The People's Bank of China
(People's Republic of China)

Japan International Cooperation Agency
(Japan)

Study on Financial System Reform for the Western Region Development in the People's Republic of China

FINAL REPORT
(SUMMARY)

February 2006

KRI International Corp.

Overseas Project Management Consultants, Ltd.

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Preface

In response to a request from the Government of The People's Republic of China, the Government of Japan decided to conduct the Study on the Financial System Reform in the Development of the Western Region of China and entrusted the study to Japan International Cooperation Agency (JICA).

JICA selected and dispatched the study team headed by Mr. Nagase Yoseki of KRI International Corporation, and consist of the Corporation and Overseas Project Management Consultants, Ltd., to The People's Republic of China, 5 times between May 2004 and February 2006. In addition, JICA set up the advisory committee headed by Mr. Hirata Masahiro, former Professor, Kyushu International University, between May 2004 and February 2006.

The team held discussions with the officials concerned of the Government of The People's Republic of China, and conducted field surveys at the study area. Upon returning to Japan, the team conducted further studies and prepared this final report.

I hope that this report will contribute to narrow regional economic disparities in The People's Republic of China and to the enhancement of friendly relationship between our two countries.

Finally, I wish to express my sincere appreciation to the officials concerned of the Government of The People's Republic of China for their close cooperation extended to the Team.

February 2006

Ueda Yoshihisa

Vice-President
Japan International Cooperation Agency

February 2006

Mr. Yoshihisa Ueda
Director
Japan International Cooperation Agency (JICA)

Letter of Transmittal

On completion of the *Study on Financial System Reform for Western Region Development in the People's Republic of China*, we would like to submit our final report. This report was compiled by a consortium comprising KRI International Corporation and Overseas Project Management Consultants, Ltd. (OPMAC), presenting the results of the aforementioned study implemented from May 2004 to February 2006 under contract with JICA.

With the regional gap becoming ever wider in China, this study was undertaken with a view to promoting sustainable development in western China, a region that occupies 70 percent of the national land mass, and was designed to yield policy-based proposals for the financial system reform. This report, having verified the direction for western region development policy, set forth a vision for regional development up to 2015 and identified development-related issues in key sectors; namely industrial revitalization, agricultural promotion, poverty reduction, and industrial infrastructure development. It raises issues and puts forward policy-based recommendations regarding financial system reform and the modalities of investment promotion, fiscal and tax administration, human resource development, and the development of legal systems.

Given the necessity of putting forward highly effective policy recommendations that are consistent with the realities of current Chinese policies and systems, interviews and questionnaire surveys were undertaken in the course of the study. Trainings on financial technologies and economic models were also provided through seminars and local workshops, in which instructive exchanges of opinions and technology transfer were successfully promoted.

The Study Team has received considerable guidance and support from JICA offices in Tokyo and in China in the execution of the study. We have also received substantial assistance from the People's Bank of China, our Chinese counterpart, the central and regional government officers of the People's Republic of China, financial institutions, and the enterprises. We would like to take this opportunity to express our deepest gratitude for their support.

Finally, it is our hope that this report will be instrumental in the development of the western region and to financial system reform and that it will contribute to international cooperation between Japan and China.

Yoseki Nagase
Team Leader
the Study on Financial System Reform for
Western Region Development in the People's Republic of China

Introduction

This report consists of four volumes: 1) Policy Recommendations, 2) Analyses of the Current State; 3) Study Areas for Priority Sectors; and 4) Technical Report; both in Japanese and in Chinese. The Japanese and Chinese versions are identical in composition and details. In addition, a summery version is presented in Japanese, in Chinese, and in English.

In the “Policy Recommendations” volume, policy proposals are presented based on comprehensive review of the results obtained from the study. It thus serves as the primary volume for the entire report. It first outlines the study and elaborates on 1) strategies and outlook for western region development; 2) issues facing the development of priority sectors; 3) reform of financial systems for different types of institutions and control over financial risks; and 4) reform of relevant systems that complement the financial system, followed by 5) actions plans for the financial system reform in the western region.

The “Analyses of the Current State” volume summarizes results of analyses conducted on the current situation. The analyses serve as the basis for the policy proposals contained in this study, describing 1) current state of the western region development and its surrounding issues; 2) state of financing for the western region development; 3) current state of the priority segments and their problems; 4) principal challenges faced by the financial system reform for the western region development; and 5) experiences of Japan and other nations in the area of policy-linked finance.

The “ Study Areas for Priority Sectors” volume summarizes results of field studies conducted in the target geographical locations for each of the four priority sectors of this study. The locations studied are Chongqing City and Shenyang City, Liaoning Province with the latter serving as a point of comparison for industrial revitalization; Dingxi District of Gansu Province for poverty alleviation; Guizhou Province for agricultural development; and Yulin District of Shaanxi Province for the industrial infrastructure development. Analytical results of surveys conducted in the target areas are also included in this volume.

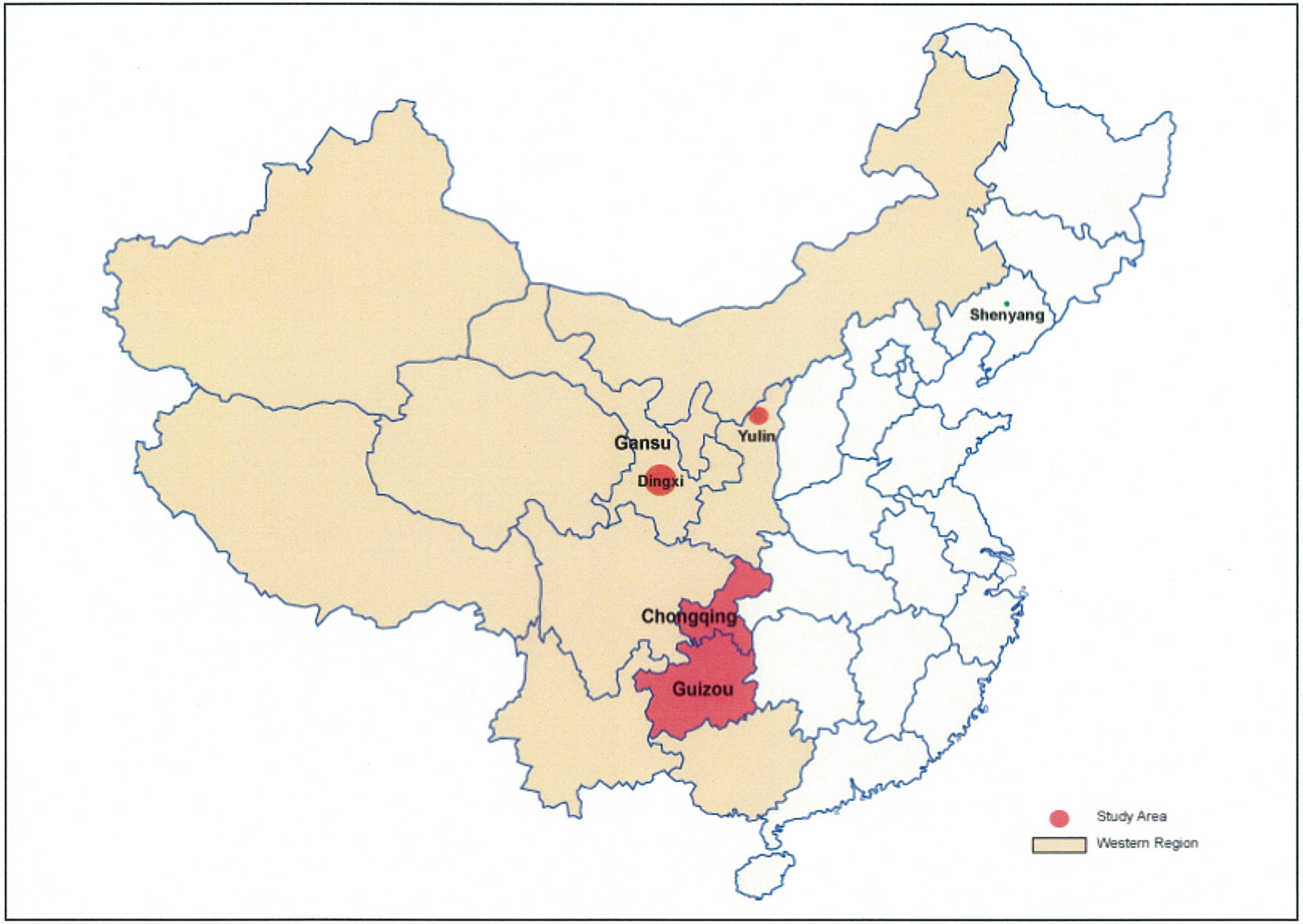
“The Technical Report” volume outlines the structures of macroeconomic and multi-regional models and forecasting techniques used for economic estimations and provides an overview of estimation techniques for capital requirements by sector.

The composition of the “summery version” exactly follows that of the “Policy Recommendations” volume. The gist of proposals is introduced in the beginning of the “summery version” for quick reference.

I hope that readers will consult and take advantage of this report for a variety of purposes.

February 2006

Yoseki Nagase
Team Leader
the Study on Financial System Reform for
Western Region Development in the People’s Republic of China


Shenyang
Yulin
Gansu
Dingxi
Chongqing
Guizou
Study Area
Western Region

Study Area

Study on Financial System Reform for the Western Development In the People's Republic of China

Final Report (Summary)

Contents

SUMMARY

1. OVERVIEW OF THE STUDY 1

1.1 Background 1
1.2 Study objective and work planning 1
1.2.1 Objective of this study 1
1.2.2 Geographical scope of this study 2
1.2.3 Structure of work execution 2
1.2.4 Study process 3

I WESTERN DEVELOPMENT: STRATEGY AND OUTLOOK 4

2. UNFOLDING OF STRATEGY FOR WESTERN DEVELOPMENT 4

2.1 Economic growth of China and the western development 4
2.1.1 Economic development and regional issues 4
2.1.2 Objectives and strategy for western development 5
2.2 Policy measures and evaluation of western development 6
2.3 Chinese economy enters a new stage 7
2.4 Future direction of the Western Development Strategy 7
2.5 Super-long term outlook on western development 8
2.5.1 Roadmap to the Year 2050 8
2.5.2 Scenario for industrial development 9
2.6 Western development and financial system reform 12
2.6.1 Aspects of promoting western development 12
2.6.2 Role of financial system reform 14

3. ECONOMIC FRAMEWORKS 15

3.1 Scenario for economic development 15
3.1.1 China's macroeconomic scenarios 15
3.1.2 China's macroeconomy and industries in 2015 18
3.2 Frameworks for the western region's economy and industries through Year 2015 19
3.2.1 Structure of regional models and simulation methods 19
3.2.2 Trends and scenario of the western region's economy in relation to the Chinese economy 20
3.2.3 Economic and industrial frameworks for the western region through 2015 20

3.3 Frameworks concerning population and daily living in the Western Region through 2015 ... 21

4. ESTIMATING CAPITAL REQUIREMENTS ... 22

4.1 Capital requirements: Underlying concepts and estimation methods ... 22
4.1.1 Scope of capital requirements ... 22
4.1.2 Estimation methods used for capital requirements ... 22
4.2 Estimated aggregate amount for investment in fixed assets for the western region ... 23
4.3 Estimates by segment ... 24
4.3.1 Capital requirements for industrial revitalization ... 24
4.3.2 Capital requirements for agricultural development ... 25
4.3.3 Capital requirement for agricultural microfinance ... 26
4.3.4 Capital requirements for the development of industrial infrastructure ... 27
4.4 Concluding remarks on estimates ... 27

5. BASIC DIRECTION FOR FINANCIAL SYSTEM REFORM WITH RESPECT TO WESTERN DEVELOPMENT ... 28

5.1 Issues to be solved for financial system reform: from perspectives of capital requirements .. 28
5.1.1 Current state of capital supply in the western region ... 28
5.1.2 Issues to be solved for financial system reform ... 28
5.2 Basic directions for financial system reform with respect to western development ... 29
5.2.1 Trends in China's financial system reform – Coping with issues from three perspectives ... 29
5.2.2 Basic principles behind the designing of financial system for western regional development ... 31
5.2.3 Responses by implementation stage ... 34

II CHALLENGES CONCERNING DEVELOPMENT OF PRIORITY AREAS AND REFORM OF FUND SUPPLY SYSTEM ... 35

6. INDUSTRIAL REVITALIZATION (STATE-OWNED ENTERPRISE REFORM) AND INNOVATION IN INDUSTRIAL FINANCE ... 35

6.1 Basic direction of innovation in industrial finance ... 35
6.2 Stronger planning and information-generation functions in industrial finance ... 36
6.2.1 Creating a team of professionals specialized in industrial finance ... 36
6.2.2 Studies on corporate finance and capital investment ... 36
6.2.3 Creation of information center for industrial finance and corporate information database ... 36
6.2.4 Creation of a group tasked with the formulation of medium-to-long term outlook ... 36
6.3 Efforts by policy-linked banks to accord high priority to industrial finance ... 37
6.4 State-owned commercial banks' shift to industrial financing ... 37

6.5 Regional financial institutions' undertaking to strengthen industrial financing functions 37
6.6 Reform of financial system for small and medium enterprises 38
6.7 Development of systems and environment that support innovation in industrial finance 38

7. AGRICULTURAL DEVELOPMENT AND INNOVATION IN AGRICULTURAL FINANCE 40
7.1 Basic approach to innovation in agricultural finance 40
7.1.1 Overcoming funding constraints 40
7.1.2 Clarification of scopes that fall on public finance and commercial finance 40
7.1.3 Realignment of rural finance to market principles and its diversification 42
7.2 Reform of agricultural policy-linked financing 42
7.2.1 Mutually complementary relationship between public budget and policy-linked financing 42
7.2.2 Policy-linked financing for agricultural development 43
7.3 Stronger corporate culture for rural financial institutions 43

8. POVERTY ALLEVIATION AND UTILIZATION OF MICROFINANCE 44
8.1 Restructuring of public budget and poverty alleviation loans 44
8.1.1 Government fund 44
8.1.2 Poverty alleviation Loan 45
8.2 Microfinance 46
8.2.1 Problems surrounding microfinance 46
8.2.2 Reform of microfinance 47

9. DEVELOPMENT OF INDUSTRIAL INFRASTRUCTURE AND FUND SUPPLY SYSTEM 48
9.1 Operator in charge of project execution 48
9.1.1 Introduction of competition 48
9.1.2 Utilization of comprehensive developmental capability of the private sector 49
9.2 Central government 49
9.2.1 Rational allocation of investment projects within the government and between the government and the public sector 49
9.2.2 Creation of a structure and mechanism that facilitate diversification of investors and sources of funds 49
9.3 Regional governments 51
9.3.1 Fostering policy formulation ability 51
9.3.2 Familiarization with market economy and opening up to the external world 51
9.3.3 Proper exercise of delegated authority 51
9.4 Domestic financial institutions 51
9.4.1 Development of banks capable of acting as lead manager in project finance 51
9.4.2 Development of legal structure allowing participation in advanced loans method 51
9.4.3 Enhanced system for credit risk control 52

9.4.4 Opening of branches by foreign banks in the western region and authorization for RMB-based transactions 52
9.5 Foreign governments and international financial institutions 52

III REFORMS OF FINANCIAL SYSTEMS 53

10. REFORM OF POLICY-LINKED FINANCIAL SYSTEM 53

10.1 Roles of policy-linked finance 53
10.1.1 Necessity of policy-linked finance 53
10.1.2 Functions of policy-linked finance 54
10.1.3 Measures to assist policy-linked financing 54
10.2 Issues relating to policy-linked financing by field 54
10.2.1 Development of infrastructure and industrial assistance 54
10.2.2 Development of agriculture, forestry and fishery 55
10.2.3 Promotion of imports and exports 56
10.2.4 Promotion of small and medium enterprises 56
10.2.5 Regional development 57

11. ENHANCEMENT OF REGIONAL FINANCIAL SYSTEMS 57

11.1 Maintaining coordination between regional development finance and national monetary policy 57
11.2 Designing systems for development according to regional characteristics 57
11.3 Boosting the function of plan coordination by the regional government 57
11.3.1 Establishing governance 58
11.3.2 Developing abilities to plan and execute a project 58
11.3.3 Promoting deregulation 58
11.4 Stabilizing finance of the regional governments 58
11.4.1 Reexamining sources of revenue for regional governments 58
11.4.2 Possibility of issuing municipal bonds 58
11.5 Enhancing region-based banks 59
11.6 Enhancing community-based lending 59
11.7 Diversifying fund suppliers 59
11.7.1 Vitalizing investment trusts that invest in the western region 59
11.7.2 Utilization of charitable trusts 59
11.8 Creation of special funds that meet the needs of regional development 60
11.9 Examining an idea of creating the western development bank 60
11.10 Introducing a special tax earmarked for environmental protection and eco-system maintenance 60

12. REORGANIZING CAPITAL MARKETS 60

12.1 Developing bond market 60

12.1.1 Diversification and expansion of bond issues 61
12.1.2 Increased funding through securitization 61
12.1.3 Issuance of municipal bonds 62
12.1.4 Fostering institutional investors 62
12.1.5 Development of basic system for the bond markets 62
12.2 Reorganizing stock market 62
12.2.1 Ensuring credibility of listed enterprises 62
12.2.2 Stability and fostering of the stock market 63
12.3 Diversifying direct financing 63
12.4 Creating a stock exchange market in the western region 63

13. DEVELOPING STRUCTURE OF THE FINANCIAL RISK CONTROL 63

13.1 Issues relating to financial risk control by the financial regulatory authorities 63
13.1.1 Risk control that addresses a shift to financial transactions 63
13.1.2 Risk control that addresses financial liberalization 64
13.1.3 Risk control that addresses growing system risks 64
13.1.4 Risk control that addresses policies for economic growth 64
13.1.5 Risk control that addresses automation of the financial sector 65
13.2 Financial risk control by financial institutions 66
13.2.1 Introducing a team in charge of ALM 66
13.2.2 Improving the check and control structure of credit risks 66
13.2.3 Introducing internal inspection structure 66
13.2.4 Preventing moral hazards 67

IV REFORMING COMPLEMENTARY SYSTEMS OF THE FINANCIAL SECTOR 68

14. OPTIMIZING INVESTMENT PROMOTION MEASURES 68

14.1 The objective of optimizing investment promotion measures 68
14.2 Raising the profile of the western region 68
14.3 Expansion of investment-related services 69
14.4 Expansion of preferential policies and improvement of the investment climate 69

15. FISCAL AND TAX REFORMS 70

15.1 Introducing tax grants into the tax allocation system 70
15.1.1 The need for reform of the tax allocation system 70
15.1.2 Outline of the tax grant to the regional governments 70
15.2 The division of public and private-sector roles in investment 71
15.2.1 Financial constraints of the local government 71
15.2.2 Private sector-led industrial development 71
15.3 Improving the quality of government spending on basic residential services 71
15.3.1 Problems with the provision of administrative services by distal government

units 71
15.3.2 Upgrades within the existing system as an interim measure 71

16. HUMAN RESOURCE DEVELOPMENT FOR THE FINANCIAL SERVICE 72
16.1 Human resource development within organizations 72
16.2 Human resource development at external organizations 72
16.3 Encouraging personnel exchanges 73

17. REFORMING REGULATORY SYSTEM FOR THE REGIONAL DEVELOPMENT AND FINANCE 74
17.1 Establishing a legal structure and principles governing policy formation and implementation 74
17.1.1 Organizing the legal structure 74
17.1.2 Adhering to the principle of "advanced legislation" 74
17.1.3 Improving legislation for regional development: establishing the Basic Law on Regional Development (tentative name) 74
17.2 Development of financial legislation 75
17.2.1 Strengthening the legal platform of policy-based financial institutions: establishing the Basic Law on Policy-based Financial Institutions (tentative name) 75
17.2.2 Developing and improving the legal system governing industrial finance 75
17.2.3 Legislating the financial disclosure of financial institutions 76
17.2.4 Strengthening penalties over illegal financial dealings 76
17.2.5 Regulating the legal structure governing Commercial Banks and Insurance 76
17.2.6 Development of legal structure governing PPP 77
17.2.7 Legal system development for financial risk management 77

V ACTION PLANS FOR "FINANCIAL SYSTEM REFORM FOR THE WESTERN REGION DEVELOPMENT" 78
18. THE STRUCTURE OF ACTION PLANS AND IMPLEMENTATION FRAMEWORK 78
18.1 The structure of action plans: principles and strategies 78
18.1.1 Three Principles 78
18.1.2 Five Strategies 78
18.2 Institutional framework for implementation of action plans 80

19. STRATEGIC ACTION PLANS 82
Strategy 1: Reform institutional finance 82
Action plan 1: Reform the policy-linked lending system 82
Action plan 2: Set up policy-based finance system to promote western development 85
Action plan 3: Develop institutional finance for agricultural development 87

Strategy 2: Reform rural finance 89
Action plan 4: Reinforce the reform process of Rural Credit Cooperative 89
Action plan 5: Pilot the credit financing through the Agricultural Producers' Association 90
Action plan 6: Strengthen microfinance in rural areas 92
Strategy 3: Foster regional banks 93
Action plan 7: Foster financial institutions and expand financial sector that serve for the community needs 93
Strategy 4: Diversify project financing 96
Action plan 8: Issue local government bonds 96
Action plan 9: Establish regional financial centers in the western region 97
Action plan 10: Full-scale facilitation of PPP (Public-Private Partnership) 99
Strategy 5: Reinforce strict financial risk management and renew finance related information, knowledge, and skills 100
Action plan 11: Develop a financial risk management system 100
Action plan 12: Develop industrial finance information center functions 103
Action plan 13: Develop financial statistical data and utilize economic models 104
Action plan 14: Foster human resources for the financial sector in the regions 105

20. ACTION PLANS FOR THE DEVELOPMENT OF LEGAL INFRASTRUCTURES RELATING TO FINANCIAL SYSTEM REFORM AND DEVELOPMENT 107

20-1: Enactment of the Basic Law on Regional Development and Regulations for Western development 107
20-2: Review current legislation on western development and overhaul the legal system 107
20-3: Establish the Basic Law on Policy-based Financial Institutions (tentative name) 108
20-4: Develop regulations on the basis of the Basic Law on Policy-based Financial Institutions 108
20-5: Develop a legal system to promote regional banks 108
20-6: Develop laws on issues of local government bonds 109
20-7: Legislate local government debt supervision / management 109
20-8: Develop the legislature to enable PPP (Public-Private Partnership) 109
20-9: Develop the legal platform to facilitate development of financial risk management systems 110

List of Figures and Tables

Figure 1-1 Structure of work execution 3
Figure 2-1 China's regional issues and western development 4
Figure 2-2 Policy structure for western development 5
Figure 2-3 The Western region's potential as industrial location – Future........ 10
Figure 2-4 Promotion of inner resource-based industry in the western region 11
Figure 2-5 Western development and role of finance in the scheme........ 13
Figure 4-1 Capital required for rural microfinance in the western region (2005 price) 26
Figure 5-1 Three perspectives for the financing of the western region........ 30
Figure 5-2 Overview of our proposals concerning financial system reform for western regional development 33
Figure 6-1 New interrelationships among players in industrial financial market 35
Figure 18-1 Action plans for the financial system reform for the western region development........ 80

Table 1-1 Details of study by phase 3
Table 3-1 Economic growth rates assumed by scenarios 17
Table 3-2 Real growth rates by GDP component and their respective shares 18
Table 3-3 Future of China's industries (Basic scenario)........ 19
Table 3-4 Real economic growth rates by region as assumed by the basic scenario 20
Table 3-5 Increases in real total product by industry and by region based on the basic scenario (Average annual rate during the period 2000-2015)........ 21
Table 4-1 ICOR estimates 23
Table 4-2 Capital requirements for industrial revitalization (entire western region)........ 25
Table 4-3 Incremental capital output ratios (ICORs) of primary industry........ 25
Table 4-4 Estimated capital requirements for primary industry in the western region (2004 price) . 26
Table 4-5 Capital requirements for industrial infrastructure of the western region 27
Table 4-6 Capital requirement for the western region(Total amount for the period 2006-2015)........ 28
Table 5-1 Issues relating to the financial system western development 34
Table 8-1 10 Areas for action and expected direct effects 47

Definition of Terms

Definitions commonly used in Japan

Policy-based finance

With this type of finance, government-affiliated financial institutions (of which there are currently two banks and six finance corporations) extend loans under more favorable terms than private-sector financial institutions with a view to achieving specific political goals.

Institutional finance

This type of financing is designed to achieve specific political goals within a more limited framework. It is statutorily based; lending terms are more concessionary, interest is subsidized and debt guarantees are provided.

Institutional finance is provided by the finance corporations as government-affiliated financial institutions, and by national (central government) and regional public corporations (local government).

The finance corporations (of which there are six, including the Agriculture, Forestry and Fisheries Finance Corporation and the Japan Finance Corporation for Small Business), which are government-affiliated financial institutions, have more limited political goals than the Development Bank of Japan and the Japan Bank for International Cooperation, and are subject to greater government involvement in that they must obtain authorization for their business and funding plans. Their main line of business is the provision of long-term, low-interest institutional financing based on the law.

The national and regional public corporations lend government funds (including interest-free loans) or implement preferential measures such as interest subsidies and debt guarantees, etc. Such measures are also categorized as institutional finance.

Development finance

This type of financing is designed to promote economic development in developing countries and/or the development of underdeveloped areas/regions within a country (the former is referred to as "official development finance", the latter as "regional development finance").

In 1986, OECD (Organization for Economic Cooperation and Development) introduced the concept of Official Development Finance (ODF), defining public lending with a grant element (GE) of more than 25 percent as Official Development Assistance (ODA) and public lending with a GE of less than 25 percent as Other Official Flows (OOF)[1]. This definition has gained international currency.

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[1] For more information on Grant Elements (GE) refer to Chapter 19, Box 19-1 of the "Policy Recommendations edition"

ABBREVIATIONS

ABS	Asset Backed Securities
ADB	Asian Development Bank
ADSL	Asymmetric Digital Subscriber Line
ALM	Asset Liability Management
ASEAN	Association of Southeast Asian Nations
ATM	Automatic Teller Machine
BAAC	Bank for Agriculture and Agricultural Cooperatives
BAC	Bank Assisted Cooperative
BAS	Business Advisory Service
BDC	Business Development Bank of Canada
BDPME	Banque du developpement des PME
BOC	Bank of China
BOT	Build-Operation-Transfer
B-SO-T	Build-Subsidized Operate-Transfer
CBO	Collateralized Bond Obligation
CCC	Commodity Credit Corporation
CDA	Cooperative Development Authority
CDAG	Cooperative Development Assistance Group
CDC	Caisse des Depots et Consignations
CDC	Community Development Corporation
CDM	Clean Development Mechanism
CDO	Collateralized Debt Obligation
CEO	Chief Financial Officer
CEPME	Credit d'Equipement des Petites et Moyennes Entreprises SA
CES	Constant Elasticity of Substitution
CFO	Chiaf Financial Officer
CGAP	Consulting Group to Assist the Poor
CGE	Computable General Equilibrium
CICETE	China International Center for Economic and Technical Exchanges
CLO	Collateralized Loan Obligation
CMBS	Commercial Mortgage Backed Securities
CMO	Collateralized Mortgage Obligation
CNC	China Network Communications Group Corporation
CNOOC	China National Offshore Oil Corporation
CNPC	China National Petroleum Corporation
CRA	Community Reinvestment Act
CRCT	China Railway Container Transport Co. Ltd.
CRFSC	China Railway Foreign Service Company

DAC	Development Assistance Committee
DCF	Discount Cash Flow
DIP	Debtor in Possession
EBRD	European Bank for Reconstruction and Development
ECGD	Export Credit Guarantee Department
EIB	European Investment Bank
EIF	European Investment Fund
ETC	Electronic Toll Collection System
EU	European Union
FmHA	Farmers Home Administration
GDP	Gross Domestic Product
GE	Grant Element
GIC	Government of Singapore Investment Corporate
GITIC	Guangdong International Trust and Investment Corporation
GMS	Greater Mekong Subregion
GRDP	Gross Regional Domestic Product
GTAP	Global Trade Analysis Project
HSBC	Hong Kong and Shanghai Bank Corporation
IBH	Investitions Bank Hessen AG
IBRD	International Bank for Reconstruction and Development
ICOR	Incremental Capital Output Ratio
IFC	International Finance Corporation
IMF	International Monetary Fund
IPO	Initial Public Offering
IT	Information Technology
JA	Japan Agricultural Cooperatives
JAPIC	Japan Project-Industry Council
JBIC	Japan Bank for International Cooperation
JECC	Japan Electronic Computer Co., Ltd.
JICA	Japan International Cooperation Agency
KfW	Kreditanstalt fur Wiederaufbau
KRI	KRI International Corp.
M&A	Merger and Acquisition
M/M	Minute of Meeting
MBO	Management Buyout
MBS	Mortgage Backed Securities
MF	Microfinance
MIS	Management Information System
MTN	Medium Term Note
NASD	National Association of Securities Dealers

NGO	Non Governmental Organization
NIEs	Newly Industrializing Economies
NOC	National Oil Company
NPO	Non-Profit Organization
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
OJT	On the Job Training
OPMAC	Overseas Project management Consultant, Ltd
PF	Project Finance
PFI	Private Finance initiative
PPP	Public Private Partnership
PWLB	Public Works Loan Board
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investors
REA	Rural Electric Administration
REIT	Real Estate Investment Trust
ROA	Return on Assets
ROE	Return on Equity
RTB	Rural Telephone Bank
S/W	Scope of Work
SAARC	South Asian Association for Regional Cooperation
SASAC	State-Owned Assets Supervision and Administration Commission
SB-O-T	Subsidize Build-Operate-Transfer
SCE	Standard Coal Equivalent
SEC	U.S. Securities and Exchange Commission
SOFARIS	Societe Francaise de Garantie des Financements des PME
SPC	Secretariat of the Pacific Community
SPV	Special Purpose Vehicle
TFP	Total Factor Productivity
TOT	Transfer-Operate-Transfer
UNCITRAI	United Nations Commission on International Trade Law
UNDP	United Nations Development Programme
VFM	Value for Money
WAIPA	World Association of Investment Promotion Agencies
WB	World Bank
WTO	World Trade Organization

Study on Financial System Reform for the Western Region Development in the People's Republic of China

Summary of Recommendations

I. Progress of the Western Region Development and Estimation of Capital Requirements

1. Deepening of the western region development is indispensable for the construction of an "all-round well-off" society.

(1) China is required to encourage social development which aims to secure the national minimum while responding to a new stage of all-round globalization, fundamental shift from economic growth relying on inefficient use of resources, and promoting balanced growth between urban and rural areas as well as among regions.

(2) From these perspectives, the western region development strategy must be reinforced and developed. To achieve this, more resources should be allocated toward education and human resource development, nurturing of industries with distinctive features, rural development, and the formation of economic networks while continued attempts are to be made for the infrastructure development and the protection of the ecosystem and environment in the western region.

2. Capital investment required for the western region development amounts to about RMB21 trillion.

According to the Study Team's estimates, required capital investment in terms of total investment in fixed assets for the ten-year period from 2006 through 2015 amounts to approximately RMB21 trillion (2004 price) (See Exhibit: Table 1).

3. To provide financial supports to the western region development, financial system reform is required.

To ensure continued supply of funds to satisfy capital needs for the western regional development, which currently relies on the government budget, the role of policy-based finance needs to be defined, and institutional reform that will give rise to a new mechanism for funding through financial markets must be launched from the long-term perspectives.

II. Principles, Perspectives, and Strategies of the Financial System Reform

1. Three principles

Principle 1: Financial system reform must contribute to attempts to overcome its underdevelopment in the western region.

Principle 2: Financial system reform must fully take advantage of financial functions based on the market mechanisms.

Principle 3: Financial system reform requires a legal foundation designed to form a sound and modern credit system.

2. Three perspectives

Perspective 1: **Perspective on the Globalization**
Steps should be taken to promote a structural change towards opening up of the financial services including the entry of the foreign financial institutions, liberalization of capital transactions, and greater flexibility in foreign exchange transactions.

Perspective 2: **Perspective on the Technological Innovations in the Financial Sector**
The financial sector should take advantages of the technological innovations including 1) diversification of the financial schemes, 2) utilization of information technology (IT), and 3) improvement of risk management.

Perspective 3: **Perspective on the Regional Gap**
Smooth flow of funds between the regional government, the financial sector, and the industrial sector in the western region should be promoted in order to correct an uneven distribution of capital, which is currently concentrated in the coastal and urban areas.

3. Five strategies

With the purpose of effective promotion of the western region development to realize more equal society, the financial system reform for the western regional development should be carried out in accordance with five strategies. These strategies are formed on the basis of the principles and perspectives mentioned above (See Exhibit: Figure 1).

Strategy 1: To redefine policy-based finance and to introduce institutional finance

Strategy 2: To reform rural finance to solve the "three rural issues"

Strategy 3: To expand and improve community-based financial services with primary emphasis on the advancement of regional banks

Strategy 4: To diversify project execution methods and financing instruments

Strategy 5: To enforce financial risk management and to refine financial information, knowledge, and skills

III. Action Plans for the Financial System Reform

The following list presents the most important action plans for the above five strategies (See Exhibit: Figure 2 for the organizational structure of proposals).

1. "Policy-linked finance" will be restructured, and "institutional financing" will be introduced.

(1) Areas of the policy-based financing will be comprehensively assessed from the following two perspectives: 1) high degree of public benefit that justifies the government assistance and 2) difficulties of assessing financial risks. Then policy-based financing will be reclassified into 1) projects to be transferred to commercial lending, 2) projects to be expanded as institutional finance[1] highlighted with long-term and low-interest rate, and 3) projects to be continued as part of general policy-based financing.

(2) The priority target area for institutional finance should be: 1) development of underdeveloped areas, 2) environmental preservation and infrastructure development for living environment, 3) agricultural development, 4) promotion of small and medium enterprises, and 5) housing for the masses.

(3) Unrestrained expansion of policy-based finance should be avoided. Thus optimization of financial means through the use of indirect financing, loan guarantee, and co-financing should be also promoted.

2. Institutional finance will be executed through the newly-established "Western Region

[1] 'Institutional finance' refers to the type of policy-based finance which is extended in accordance with certain statues for the purpose of achieving specific policy objectives of more limited scope. It may take the form of loans (low interest rates, long-term), interest subsidiaries, loan guarantees and other arrangements whose terms are more concessional than those available under ordinary policy-based financing. In Japan, institutional finance is carried out by government-affiliated finance corporations, the nation (central government), and local public entities (regional governments).

Development Fund" by utilizing the existing organization and functions of the China Development Bank.

(1) A framework of supplying long-term, low-interest rate policy-based funds in the western region should be created to finance projects in extremely underdeveloped areas and projects that offer high socio-economic benefits but low profitability.

(2) For this purpose, the Western Region Development Fund (the Fund) should be created as an institution to dedicate to financing projects for the development of basic infrastructure, environmental conservation, agricultural development, promotion of micro, small and medium enterprises, and other designated fields in the western region. The Fund operation shall take full advantage of skills, knowledge, and information accumulated in the China Development Bank (See Exhibit: Figure 3).

(3) Financial resource of the Fund should be secured by consolidating and streamlining funds from the treasury bonds and treasury account of the central government as well as subsidies from the central government to the local governments.

3. In light of the importance of the "three rural issues" in the western region, a fundamental reform will be launched for the agricultural and rural financial systems.

(1) Institutional finance for the agricultural development should be introduced to provide credits to farmers who bear the expenses for the comprehensive agricultural development project, agricultural infrastructure projects, and modernizing the farming practice. It is suggested that this will be implemented on an experimental basis by setting up an agricultural development account in the Agricultural Development Bank of China and injecting the public fund into the account. Results of the experiment will be assessed, and the role of the Agricultural Development Bank of China will be defined before making a decision on how and in what organizational style this institutional finance for the agricultural development will be rolled out nationwide.

(2) With respect to rural credit cooperatives, reorganization and business restructuring in accordance with the existing principles should be promoted. With the purpose of ensuring the delivery of high-quality services that correspond to the financial needs of rural society, the initiative of each credit cooperative for its reform should be supported through various measures including the introduction of a financial auditor system.

(3) Given high expectations placed on the evolution of 'cooperative unions', it is recommended that credit services (credit guarantees and loans subleasing to members) will be carried out on an experimental basis by farmers' cooperatives in the western region to facilitate the institutionalization of financing by cooperative unions.

(4) For the alleviation of poverty, rural microfinance will be strengthened through 1) a more diversified

roster of providers, 2) operational improvements including review of interest rates and other terms of lending, and 3) building of a support structure with reinforced relationships with technical assistance institutions.

4. Rural financial institutions will be fostered with the goal of enhancing the delivery of community-based financial services.

(1) The local commercial banks should strengthen their services by creating a business model which serves the needs of the community with a vision and by taking initiatives in creating the model.

(2) An optimal system will be examined for the legalization of the private finance businesses (non-banks). A model business will be launched, and the structure of supervision and control for such businesses will be developed.

(3) Evolution of the postal savings bank as a community-based financial institution will be encouraged, and a mechanism for the regional circulation of the postal savings will be established.

5. Public-Private Partnership (PPP) will be launched on a full-fledged basis to meet enormous capital demand for investment.

(1) The priority for the government funding should be given to projects with little prospect of generating sufficient return on investment. For projects capable of generating sufficient return, the most reasonable scheme will be selected from the PPP (public-private partnership) methods according to the characteristics and degree of marketization of individual projects.

(2) For this, more diversity in the roster of project operators will be achieved for the development of industrial infrastructure, and parallel to this, a system will be developed to facilitate the project operators' fund-raising from the market.

(3) Furthermore, efforts to develop human resources capable of utilizing advanced financial technology, legal systems, and risk control structure appropriate with the PPP structure will be developed.

6. Other action plans

(1) Full study should be made on the local government bonds and setting the conditions for issuance. The local governments which satisfy the requirements shall be authorized to issue their bonds on a trial basis for financing projects such as the urban infrastructure.

(2) In light of the necessity to expand capital markets in the western region, regional financial centers will be developed in some major cities.

(3) A financial risk management system will be developed through the launch of plural inspection

systems, utilization of the capital adequacy ratio rule, and the introduction of a fund for mutual financial support for the western region.

(4) Industrial financial information centers will be set up in some major cities in the western region for the development of a system which accumulates and utilizes corporate credit information databases.

(5) Attempts will be made to refine financial statistics and data, to expand and enhance study analyses, and to increase the use of economic models in a region.

(6) In light of the importance of human resource development for small and medium-sized regional financial institutions in the western region, three steps shall be taken: 1) introduction of competency certification systems for the financial business, 2) the formation of an education and training network of personnel engaged in financial services, and (3) the expansion of educational and training programs.

IV. Development of the legal structure for the financial system reform

1. Development of the legal structure for the regional development

(1) In order to create foundations for the legal structure relating to the regional development, the Basic Law on Regional Development (tentative name) will be promulgated, followed by the enactment of the Regulations for the Western Region Development (tentative name).

(2) Along with the above legislations, the existing statutes relating to the western region development will be reviewed to put the entire legal structure in perspective.

2. Development of the legal structure for financial structure

(1) It is important that comprehensive legal foundations for policy-based banks be established in order to prevent their excessive commercialization and to ensure proper execution of policy-based financial functions which they have been entrusted with from the beginning. For this purpose, the Basic Law on Policy-based Financial Institutions (tentative name) will be enacted, and attempts will be made to add transparency and to standardize the formation and operation of various policy-based financial institutions.

(2) In view of the fundamentality of the above law, the enactment of the Regulations for the Western Region Development Fund will be assumed for the Western Region Development Fund.

3. Development of the legal structure for action plans

Legal structure will be developed for recommended action plans in this report; namely, 1) development of regional banks, 2) issuance of the local government bonds, 3) supervision and control by regional governments over debt positions, and 4) enactment of the Realty Appraiser Law, the Civil Conservation Law, and the Civil Enforcement Law in support of the PPP method, and 5) setting the legal structure for controlling the financial risks including the Bankruptcy Law.

(End)

Exhibit: Table 1

Capital requirements by the western region (Total for 2006 through 2015)

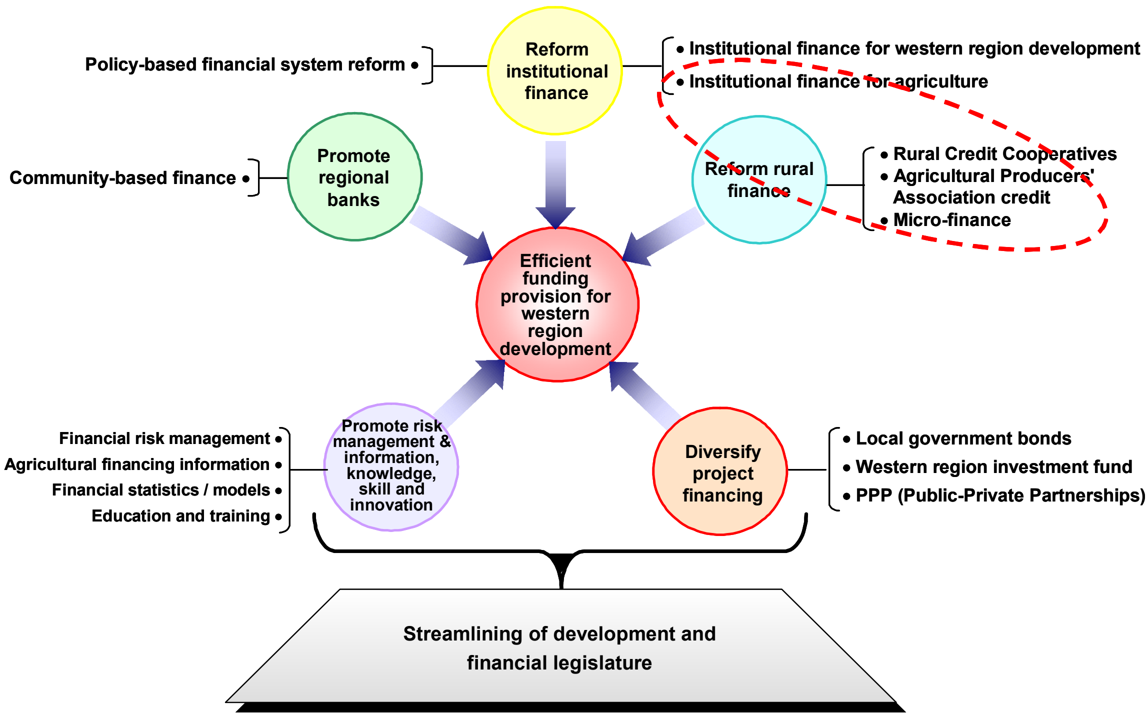
(Unit: RMB trillions)

	Required capital	Percentage to total
Total requirements for investment in fixed assets	20.90	100.00%
Industrial revitalization	10.02	47.90%
Agricultural development	1.09	5.20%
Rural microfinance	0.17	0.81%
Industrial infrastructure	2.01	9.61%

(Source) JICA Study Team

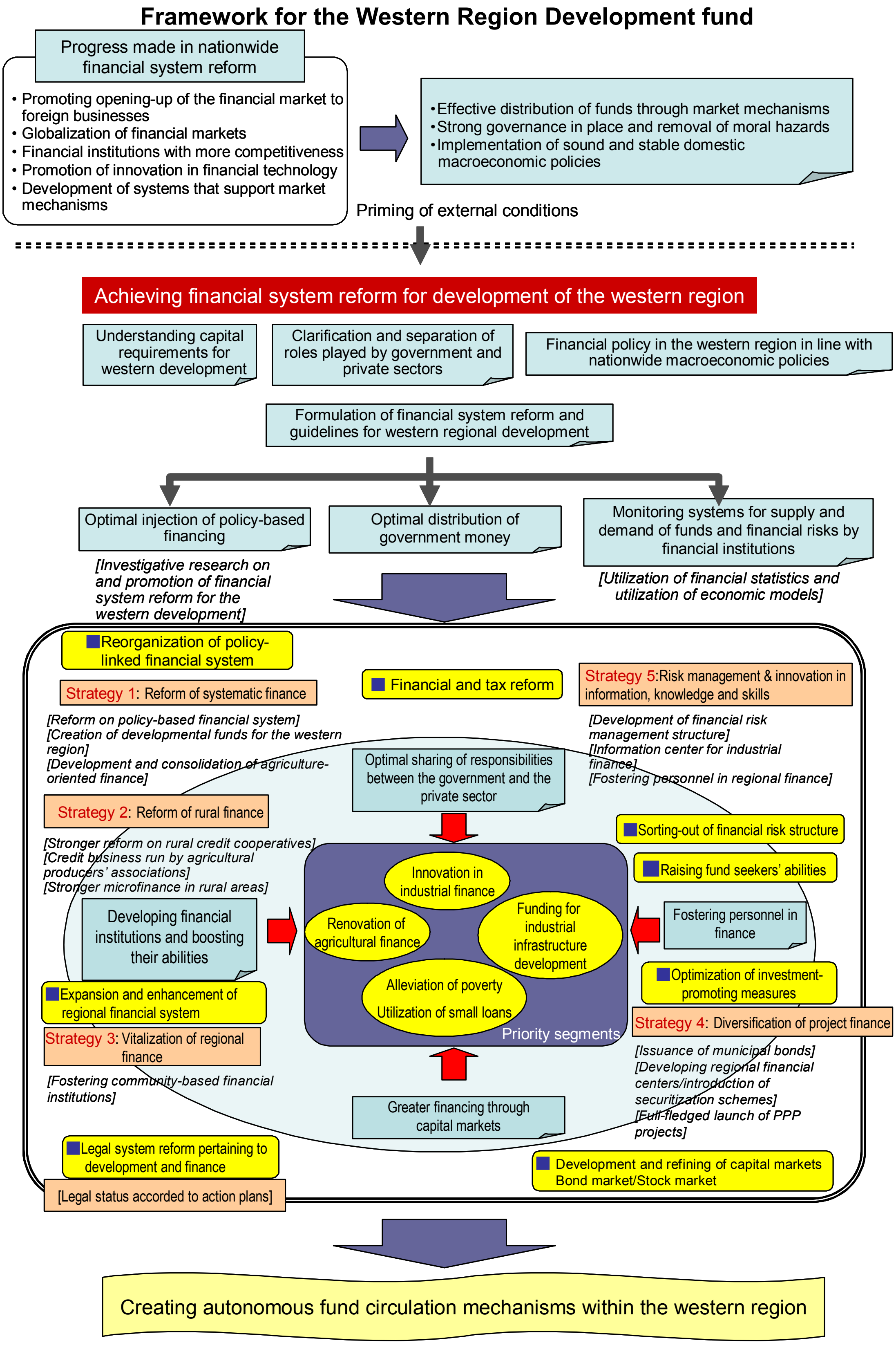
Exhibit: Figure 1

Action plans for financial system reform for the western region development



Source: JICA Study Team

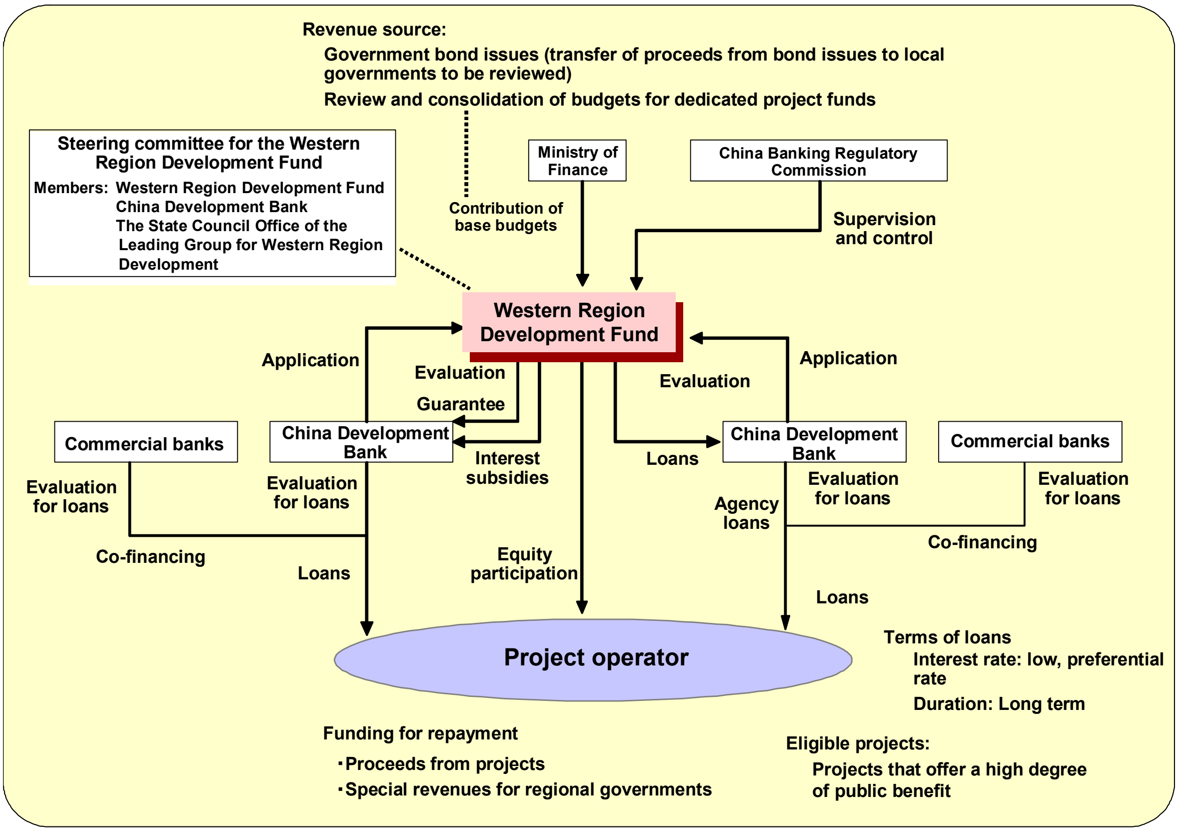
Exhibit: Figure 2



Source: JICA Study Team

Exhibit: Figure 3

Framework for the Western Region Development fund



Source: JICA Study Team

Summary

1. Overview of the study

1.1 Background

China's western region, which accounts for about 70 percent of the nation's land area, has lagged behind other parts of the country in terms of labor productivity and market competitiveness. This can be explained by (1) harsh natural conditions that characterize the yellow-soil belt along the middle reaches of the Yellow River, the desert zone in the northwest and the mountainous southwest (2) higher costs to reach the global market due to the region's inland location far from the coast (3) an underdeveloped transport network and (4) low educational standards. As a result, the divide between the western and coastal region is increasingly visible.

Against this background, the Chinese Government, calling for "balanced development of the national land" as a state-wide development challenge in the Tenth 5-Year Plan (dubbed "10 5") adopted by the 9th National People's Congress in March 2001, unveiled Western Development, which aims to eliminate economic disparity between the inland (west) and the coastal area (east). It subsequently shifted the geographic focus of its investment policy away from the coastal area and toward the west in an effort to facilitate the execution of pro-development initiatives, including large-scale infrastructure building. The development of transportation infrastructure, including railways and roads, and of a better investment climate to lure private-sector and foreign investment is of urgent importance in order to build solid foundations for the sustainable western development. In China, financial system reform, along with administrative reform and state-owned enterprise reform constitute the three pillars of the reform policy platform. Currently, financial system reform is not always making smooth progress. To strengthen financial functions, comprehensive reform of the system is required.

In these circumstances, more efficient raising and management (through loan disbursements, among others) of funds are needed for sustainable western development. To this end, capital requirements for investment in the western region have to be clarified while optimization and diversification of funding methods should also be achieved. Financial systems that are specially designed to aid development need to be restructured, and laws that concern developmental initiatives must be drafted and firmly set in place in order to reduce reliance on fiscal investment and loan programs, and to encourage robust investment from the private sector and overseas.

Based on the above understanding, the People's Bank of China (hereinafter PBC) requested that Japan conduct this study. In response, the Japan International Cooperation Agency (hereinafter JICA) dispatched a preliminary study team in December 2003 to discuss the framework of the study. It signed the Scope of Work (S/M) and Minutes of Meeting (M/M) on January 20, 2004.

1.2 Study objective and work planning

1.2.1 Objective of this study

The purpose of this study is to contribute to the sustainable western development through financial system reform. Attempts are made to present the ideal state of the financial system, efficient funding methods, necessity of developing and updating relevant laws, and the role to be played by the central and regional governments.
Because this study takes the form of policy recommendations, much emphasis was placed on communication with Chinese counterparts in the course of the study and execution of the technical transfer needed for our Chinese partners to take full advantage of our proposals.

1.2.2 Geographical scope of this study

This study covers the entire western region[1]. Upon consultation with the Chinese organs in charge of related work, a geographical area subject to detailed investigations was decided for each policy segment. These are:

i) Industrial revitalization (state-owned enterprise reform):	Chongqing City
ii) Agricultural development:	Guizhou Province
iii) Poverty policy:	Dingxi District, Gansu Province
iv) Industrial infrastructure development:	Yulin City, Shaanxi Province

For i) above, Shenyang City in Liaoning Province was selected as a point of reference against which comparisons were made for industrial revitalization purposes, and relevant information and data were also collected in Shenyang.
In addition, information was gathered as needed in advanced economic areas of China and the respective provincial capitals of the areas covered by this study.

1.2.3 Structure of work execution

(1) Structure of work execution by Japanese parties

1) Japan International Cooperation Agency (JICA) China Office
JICA China, which acted as the body principally responsible for this study within JICA, managed and supervised the study, while the Social Development Department of JICA headquarters provided assistance to JICA China as needed.

2) Domestic Assistance Committee
JICA created the Domestic Assistance Committee, where JICA, the domestic committee members, and the study team held joint discussions and examinations with respect to the direction to be taken for the study and details to be proposed by the study team.

3) JICA Study Team
Organized through collaboration between KRI International Corp. and Overseas Project Management Consultants, Ltd. (OPMAC), the 17-member JICA Study Team was commissioned by JICA to carry out this study.

4) Local Information Exchange Sessions
To support the study team in China, JICA China periodically hosted local information exchange sessions. The Embassy of Japan in China, the Beijing Representative Office of the Bank of Japan and the Beijing Representative Office of Japan Bank for International Cooperation participated in the sessions.

(2) Structure of work execution by Chinese partners

1) Counterpart organs
The Research Department of PBC served as the Chinese counterpart for the purpose of this study. Its duties included, among others, consultation with the study team with respect to execution procedures of the study, provision of services and convenience to the study team, consultation with respect to matters to be proposed, and consultation with respect to preparation for workshops and seminars.

2) Working Group
The Research Department of the PBC set up a working group for the execution of the study. The core

[1] For the purpose of this study, the "western region" refers to 12 areas, consisting of the City of Chongqing, the Provinces of Shaanxi, Sichuan, Guizhou, Gansu and Qinghai, and the Autonomous Regions of Inner Mongolia, Ningxia Hui, Tibet, Xinjiang Uygur and Guangxi Zhuang.

members of the Working Group included the vice heads of the PBC's regional branches and the heads of the PBC's research institutes located within the geographical scope of the study, in addition to the members of the Research Department.

3) Steering Committee
Headed by the Director of the PBC's Research Department as chairperson, and participated in by those from the Ministry of Finance and the State Council Office of the Leading Group for Western development of the State Council, the Steering Committee dispensed advice pertaining to this study.

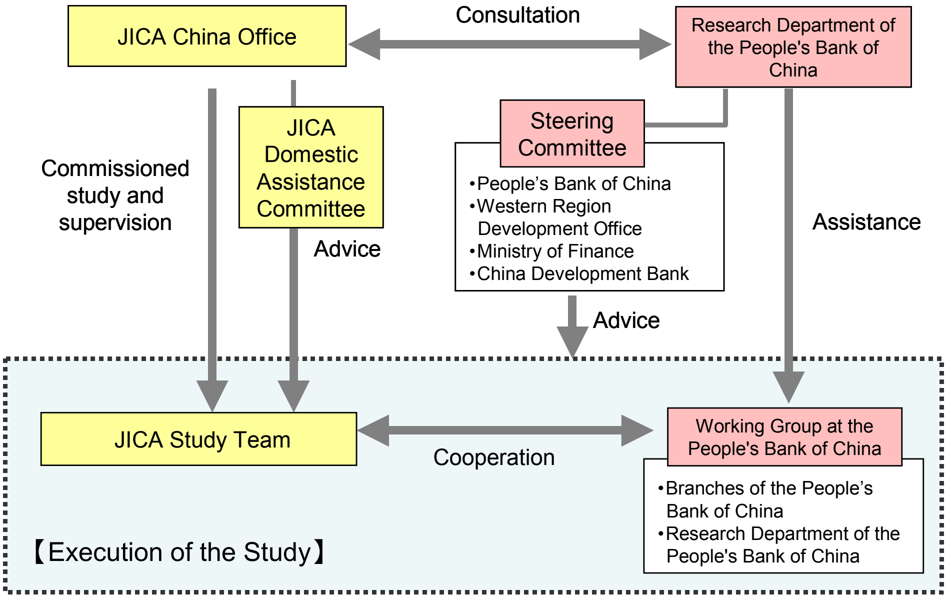


Figure 1-1 Structure of work execution

1.2.4 Study process

The study process was divided into the following three stages

Stage I: Analysis of present situation relating to China's financial system
Stage II: Identification of major issues, investigation of measures, sharing of Japan's past experiences, and examination of promising financial policies and systems to be implemented in the western region
Stage III: Overall evaluation and proposals

The above three stages were further divided into the following phases, which reflected details of work.

Table 1-1 Details of study by phase

Stage I	[Year 1] (May 2004 through March 2005)
	<<Preparatory Phase>> Collection of relevant information and data and building of a structure that facilitated the execution of the study
	<< Phase 1>> Analysis of current situation and sorting out of issues
Stage II	<< Phase 2>> Identification of major issues and investigation of measures
	[Year 2] (April 2005 through February 2006)
	<<Phase 3>> Examination of promising financial policies and financial structure to be implemented in the western region
Stage III	<<Phase 4>> Preparation of overall evaluation and proposals
	<<Phase 5>> Preparation of final report

I. Western Development: Strategy and Outlook

I Western Development: Strategy and Outlook

2. Unfolding of strategy for western development

2.1 Economic growth of China and the western development

2.1.1 Economic development and regional issues

Since the its reform and open-door policy was launched in 1978, China has demonstrated dynamism on an enormous scale unprecedented in world history. This has given rise to sustained high economic growth and development for a quarter of a century. The dynamism exhibited in economic development has brought about changes in four directions (1) marketization (2) internationalization (3) industrialization and (4) urbanization.

Given China's vast territory, the conditions and foundations for economic growth vary greatly from region to region. Generally, change in the systems that affected the nation in the four directions stated above was easily digested by the coastal eastern region, which was relatively adept at the new systems. Dynamism for economic growth shown in the eastern region was intense, while the western region remained in a relatively inferior position. This spatial structure is inherent in the dynamism displayed by China's economic development. This has resulted in uneven economic growth among different regions of China and exacerbated the three regional issues described below.

The first issue concerns regional disparity. In addition to regional disparity between the eastern region on one hand and the central and western regions on the other, the disparity between urban areas and rural areas within the same region has widened. The second issue is the emergence of megalopolises. The accelerated concentration and buildup of population and industry primarily in the coastal, eastern region and the subsequent clustering of urban districts are giving rise to a series of megalopolises that are among the largest in the world. Explosive growth of urban centers raises new concern over (1) disorderly expansion of urban areas (2) delayed development of urban infrastructure and (3) income disparity among urban dwellers. The third issue is the development of China's interior. Two challenges need to be addressed. One is how to encourage autonomous development of the region while overcoming severe natural conditions and disadvantages inherent in the inland region. The other relates to the question of how to create a national production system from nationwide perspectives – by means of measures designed to take advantage of the resources available inland for the benefit of the entire nation, combined with initiatives that strengthen ties between the inland and the coastal region while paying sufficient attention to environmental protection. The Western Development Strategy might be interpreted as a policy that addresses both of the above in an integrated manner (See Figure 2-1).

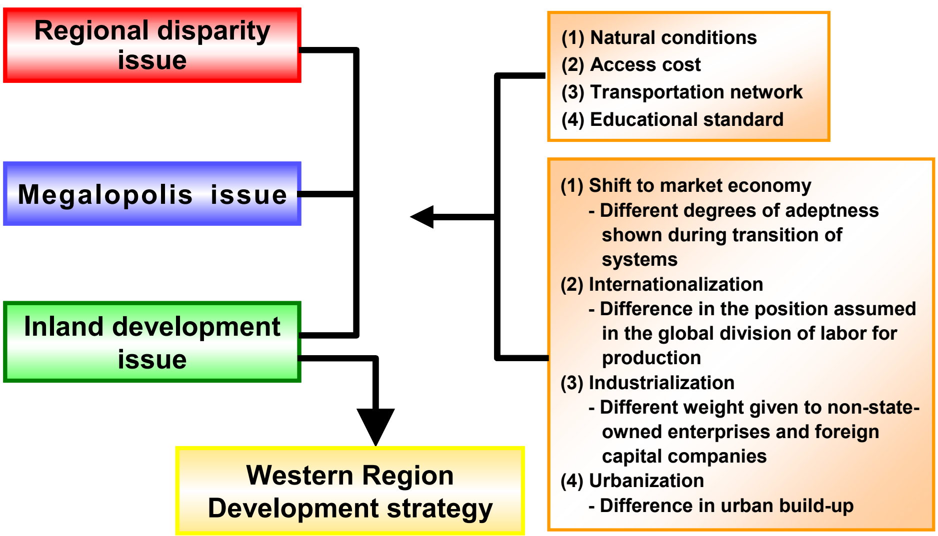


Figure 2-1 China's regional issues and western development

2.1.2 Objectives and strategy for western development

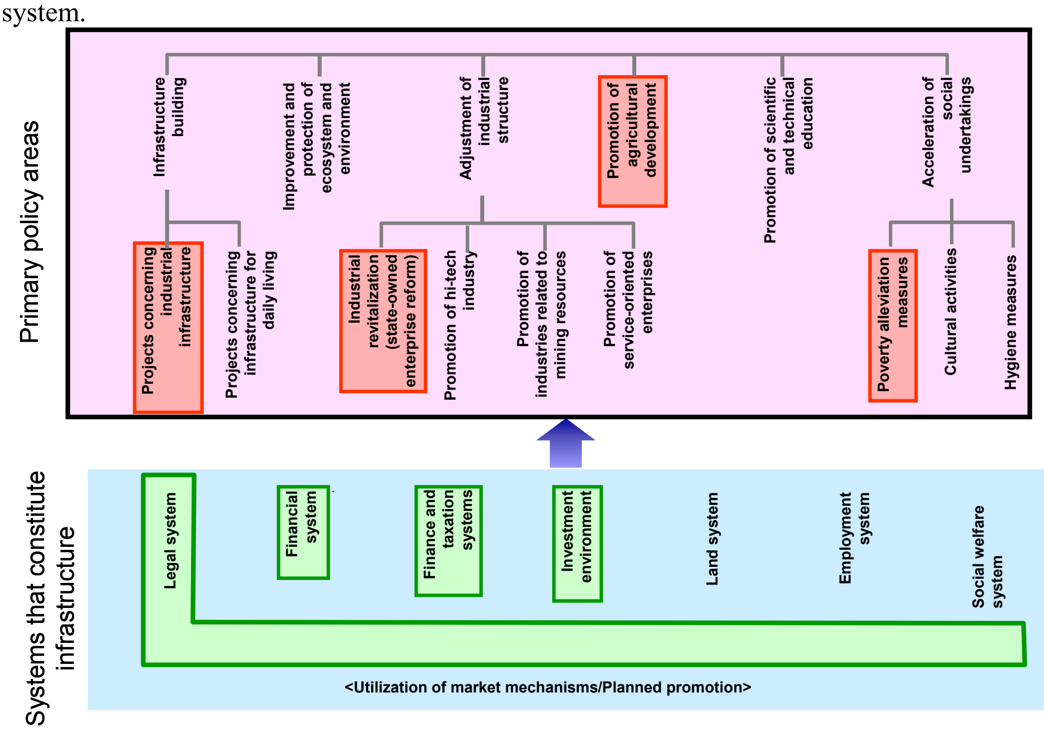
(1) Objectives for western development

Developing the west is an attempt to bring the relative backwardness of the region to a radical halt, to narrow regional disparity, and achieve "shared wealth", which will rest on the nationwide realization of a "well-off society." It is targeted for completion before the mid-21st century, when the entire nation is expected to have achieved fundamental modernization. In a nutshell, it is an attempt to ensure "balanced growth of the entire nation".

(2) Strategy for western development

Basic strategic means to achieve these objectives are: (1) infrastructure building that serves as a basis for development (2) preservation of the ecosystem, which is at the root of the development (3) adjustment to be made to the industrial structure, which is at the core of the development (4) science and technology, education, and human development which ensure development and (5) reform and open-door policies, which drive such development.
Development of the west is a long-range challenge for the development of the nation, and orderly, planned and step-by-step execution in particular is critical. Therefore, special emphasis is placed on achieving "breakthrough progress" in the region, first in the areas of infrastructure building and ecosystem preservation by 2010 or so, to pave the way for further development.

Based on the objectives and strategy described above, primary policy areas to be addressed were set forth, as shown in Figure 2-2 below. As stated in 1 above, we selected the following topics out of the primary policy areas as the primary focus of this study: (1) industrial revitalization (reform of state-owned enterprises) (2) agricultural development (3) poverty alleviation measures, which are part of a larger social-work policy, and (4) development and streamlining of industrial infrastructure, which is part of undertakings aimed at infrastructure building.
Of the systems that constitute infrastructure, this study primarily addresses: (1) the financial system which is at the fundamental core (2) finance and taxation (3) the investment environment and (4) the legal system.



Note: Items in rectangles indicate the present study's central topics and focused areas.

Source: JICA study team

Figure 2-2 Policy structure for western development

2.2 Policy measures and evaluation of western development

(1) Policy measures for western development

Initially proposed by the then Chairman, Mr. Jiang Zemin, in 1999 in his "Xian Lecture," Western Development is a comprehensive regional development policy which was put into action in 2000 as a state-level, long-range development strategy of importance.
Policy measures formulated to enable the six primary areas of policy concern listed in Figure 2-2 are concentrated in the following eight fields:

(1) Policy concerning finance
(2) Policy concerning additional capital injection
(3) Measures for preferential tax treatment
(4) Policy measures concerning sustainable development, utilization and resource protection
(5) Policy measures for greater opening up to the world
(6) Policy measures that assist and encourage East-West collaboration
(7) Policy measures designed to strengthen assistance by dispatching more people
(8) Policy measures that promote social progress in the areas of science and technology, education, culture and hygiene, among others

(2) Evaluation of execution of the development policy

It has been over five years since the launch of the Western Development Strategy. In this period, both the central and local governments made attempts to administer relevant policy measures in an effort to halt the growing disparity between the western and eastern coastal region and to overcome challenges that existed in a variety of spheres, including infrastructure, ecosystem and environment, water resources, energy, agriculture and daily life.

With the implementation of the Western Development Strategy, total investment in fixed assets directed to the region rose sharply at an annual rate of about 20 percent. In the most recent three-year period, over 40 percent of the proceeds from the long-term construction T-bonds were allocated. Stimulated by public investment, private-sector investment poured in and accelerated annual GDP growth, which now stands at 10 percent on average. The fact that the western region's GDP growth has recently been picking up speed year on year should merit special attention.
With a slight acceleration in GDP growth of the region, the gap with the eastern region is gradually beginning to close. Although the difference in the absolute level of GDP between the western and eastern regions is growing, further widening of the gap is coming to a halt, thanks to the Western Development Strategy.
Solid progress has also been made in the sphere of infrastructure building for the western region. The entire length of the West-to-East Gas Pipeline went into service less than three years after construction launch. Construction is in full swing for other large-scale projects such as the West-to-East Power Transmission, the Qinghai-Tibet Railway, and freeway networks.

One challenge for development of the region is that the sharp rise in investment does not necessarily trigger the autonomous mechanism for economic development. This is attributable to three factors.

First, western development lays stress on infrastructure development and ecosystem and environmental preservation, with relatively little focus on industrial development. Therefore, measures that actively support sustainable industrial development are not adequately provided.

Second, many examples suggest that large state-level projects do not always bring anticipated benefits to the local level in terms of partnerships with local economy and synergies to benefit the local economy.

Third, the investment climate and especially the intangible aspect of this environment remain poor, and industries in the western region are not competitive enough.

Moreover, the following problems have surfaced with respect to the system and structure of capital injection for western regional development, although national policies call for more funds to be allocated to western development from the central finance's construction funds.

First, the allocation structure and allocation limit with respect to funds provided for western development from central finance are not based on any code or rule, thus making them unstable.

Second, the position of the Development Bank in the scheme of the Western Development Strategy is rather elusive.

Third, loans on preferential terms from international organizations and foreign governments are on the decline.

Fourth, aside from the region's lack of stable fund sources based on certain codes, market mechanisms for the capital market, especially mechanisms of commercial finance and private-sector finance, are not in place in the western region.

The above suggests that future directions of the Western Development Strategy need to be clarified further to correct the imbalance between regional economies, especially in the face of the challenge posed by the concentration and buildup of economic activity in the eastern coastal region.

2.3 Chinese economy enters a new stage

Western Development is a vision with an extremely long time horizon which stretches all the way to the middle of this century. Five years have passed since the policy of developing the western region was unveiled. Given the extremely long time span it covers, the last five years can be viewed as a preparatory stage. It is time for China to refine and enhance its strategy for the next five years and subsequent five-year periods, based on the experiences and achievements of the last five years.

Internal and external conditions surrounding the Chinese economy are changing rapidly. Of particular interest is the Eleventh Five-Year Plan for 2006 through 2010, which is scheduled to come out in March 2006. Based on the new Five-Year Plan, the Western Development Strategy is expected to have some new twists, while regional and local governments of different levels in the region will draft their new plans. Needless to say, directions and details of such plans will become available after the release of the plans.

Policy challenges faced by the Chinese economy generally falls into the following five areas:

(1) Transition from "growth relying on inefficient use of resources"
(2) Ways to deal with "all-round globalization"
(3) Formation of "national land and space in harmony"
(4) Emphasis on "social development"
(5) Promotion of "regime reform"

2.4 Future direction of the Western Development Strategy

It is essential that the Western Development Strategy unfolds in line with the Chinese economy's transition to a new stage, as stated above. Now that all four regions[2] of China have been accounted for in regional development policy, some think the importance of western regional development has

[2] Eastern, central, and northeastern regions in addition to the western region

declined. However, detailed observations of reality uncover great strains and contradictions that have grown out of high economic growth, and without doubt they manifest themselves in the western region in a symbolic way. In light of this reality, it is suggested that the development policy for the west be strengthened and put into action for the realization of a well-balanced, "all-round well-off society" for the future.

The basic strategy for western regional development for the first decade of the 21st century stresses development of the physical infrastructure, and ecological and environmental improvements. Intensive capital injection is directed to these two areas to allow rapid improvements, which in turn are expected to open the way for further development of the region. In light of its intrinsic character, this basic strategy should be continued and expanded further.

On the strength of infrastructure building and environmental preservation, stronger focus will be made on education, industries, and rural villages. Fundamental undertakings in these areas will have to be taken since they are essential in nurturing human resources, creating job opportunities and solving the "three rural issues" in the face of challenges posed by all-round globalization and social development. The following perspectives and directions need to be taken into consideration for further expansion and enhancement of the Western Development Strategy.

(1) Importance of human assets
(2) Industrial revitalization and development of local industries
(3) Solutions addressing the root causes of the three rural issues
(4) Formation of multi-layered urban systems and active functional area
(5) Focused and intensive infrastructure development
(6) Securing of the national minimum

2.5 Super-long term outlook on western development

2.5.1 Roadmap to the Year 2050

Western regional development is a vision for the super-long term, targeted for completion in 2050. This time span was accorded to the development in light of harsh natural conditions and poor access to the eastern coastal region with its massive industrial buildup and international ports. It would be proper to divide the fifty-year period into the following developmental stages:

(1) Stage I: Foundation Building (2000-2010)

The first half of the decade (2000 through 2005), which coincided with the Tenth 5-Year Plan, was dubbed the preparatory stage. Efforts to build infrastructure and protect the environment were given priority, as these would serve as foundations for full-fledged western regional development.
The second half of the decade (2006 through 2010) will be under the Eleventh Five-Year Plan. The new Plan is in the final drafting stage. As stated earlier, stronger focus is expected on education and human development, promotion of the development of industries with distinctive features, and comprehensive revamping of rural villages while infrastructure building and environmental protection efforts continue.
The objectives of this ten-year Stage I are to put a check on growing regional disparity, and to complete the basic infrastructure essential to future growth of the western region.

(2) Stage II: Stable Growth (2011-2020)

This is the stage characterized by accelerated urbanization, full-fledged growth of industries with relative advantages, improving growth rate relative to the eastern region, and gradual narrowing of disparity. However, GDP per capita of the western region in 2020 is expected to considerably lag behind the national average, which is likely to reach US$3,000.
Stage II will see accelerated development and improvements in urban and rural areas parallel to

urbanization. Gradually they pave the way for the formation of hierarchical urban systems and of functional blocs and areas. In synch with such undertakings, a buildup of industries noted for distinctive features and industries with competitive advantages will accelerate. This will set off a positive cycle of employment-income-consumption, which will help boost the position of the western region as a domestic market. These factors will allow further organic integration of the west with the east.

(3) Stage III: Modernization (2021-2050)

During Stage III, in which the entire nation will strive to achieve modernization, the eastern region is expected to face a variety of limitations inherent in its massive buildup, and its economic growth will slow down. The west, on the other hand, could enjoy an accelerated pace of growth in terms of per capita GDP, which is partially explained by declining population. Consequently, the nation will move toward a more balanced society stressing common prosperity while greater globalization is achieved.
The advances of the three economic corridors of the western region, in greater cooperation with the eastern megalopolises, are expected to facilitate more even development of the entire nation. Another factor of special concern is the rapid aging of society which will affect China during Stage III, with welfare, care for the elderly and disbursements for social security becoming major issues. Therefore, necessary preparation should be made in the next two to three decades for the impending graying of society by building solid foundations, utilizing the fruits of high growth. As 2050 approaches, upgrades to the nation's infrastructure built after the 1980s will become due en masse. Social costs for repairs and upgrades of such infrastructure will claim an increasingly large portion of total investment in fixed assets.

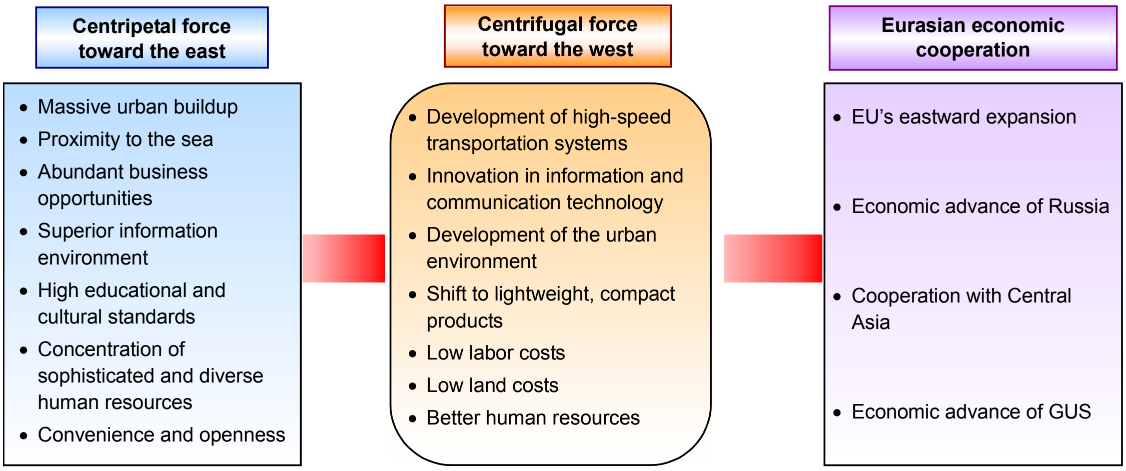
2.5.2 Scenario for industrial development

(1) Changes in factors affecting locations of industries

It is observed that a strong centripetal mechanism toward the eastern coastal region is at work in the Chinese economy, as it goes deeper into production and trading partnerships with the rest of the world. Noted for a world-class urban buildup on gigantic scale, the east's already massive accumulation is luring more accumulation and driving further urbanization, which is giving rise to megalopolises, including regional economic centers like the Pearl River Delta, the Yangtze River Delta, and the Beijing-Tianjin Greater Metropolis, among others. With the growth of megalopolises, however, more challenges affect these areas, leading to deterioration of the urban environment. Economic growth of megalopolises will eventually run its course by reaching the limits imposed by an increase in negative externalities.

Meanwhile, the western region is expected to benefit from shorter traveling time to and from the eastern coastal region and reduced costs for transporting goods, as high-speed air, land and rail transportation systems are completed. Moreover, advances in information and communication technology, and information networks in particular, will encourage trans-regional division of labor for production and services. Urban development projects will enhance and improve the urban environment, and better education and human resource development will produce skilled and qualified people. Inexpensive labor and land will become increasingly visible advantages offered by the western region. In the long run, all of these factors will act as a centrifugal force toward the region.

In addition, the geographical location of the region, at the eastern end of the Eurasian Continent, could work in its favor, offering new growth opportunities. In particular, the EU's expansion into the East, Russia's economic advances, and economic development of the Greater Mekong Subregion (GUS) are factors. The western region will have to fully understand the potential consequences of these new developments in surrounding areas and take part in the formation of a greater economic cooperation zone promoting international trade, division of labor, and tourism within the zone in order to take full advantage of this new impetus for its own development.



Source: Figure prepared by the Study Team

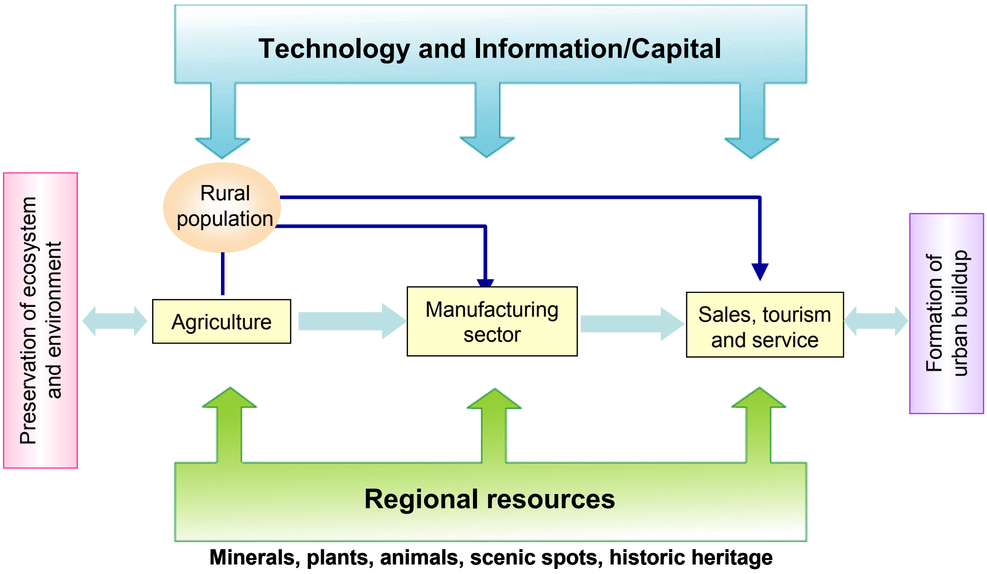
Figure 2-3 The Western region's potential as industrial location – Future

(2) Promotion of spontaneously developed industries with distinctive features

The scenario for the western industrialization should be based upon development of inner resource-based industry while taking advantage of the above-mentioned changes in the locational advantages of the western region.

Strong emphasis must be placed on the promotion of local industries from within, which is dubbed spontaneously induced "industrialization from below." First, the resources available in the region, which are abundant and diverse, ranging from minerals, animals and plants, to scenic spots and historic heritage, must be fully tapped for the unique promotion of agricultural and forestry activities. Some products generated from the primary industry are passed on to the manufacturing sector for value-added processing, and are shipped for sale in the region, making them available for tourism and service sectors, or are transported out of the region. Thus efforts must be made to promote the development of inner resource-based industries by strengthening an industrial chain within the region to bridge the primary, secondary and tertiary industries.

Surplus labor available in rural areas will be absorbed by employment opportunities created by the non-primary industry, which is expected to grow in the region, thus leading to more stable employment and income throughout the region. Through this industrial development and labor migration, urban buildup will enter a higher stage, forming a mechanism of positive interactions between industrial buildup and urban buildup. To promote the inner resource-based industries, capital along with technology and information must be supplied (See Figure 2-4).



Source: JICA Study Team

Figure 2-4 Promotion of inner resource-based industry in the western region

(3) Flying-Geese Pattern of Development for Labor Intensive industries

In retrospect, the evolution of East Asian economic development is explained by a flying-geese pattern of industrial development based on a chain of structural transitions firstly occurred in Japan, which affected newly industrialized economies (NIEs), followed by ASEAN nations and finally China. East Asia's dynamic development has been maintained through each nation's effort to specialize in the industrial production where it has comparative advantages. This in turn has helped build a division of labor across national frontiers. This flying-geese pattern of development may take place not just across national borders as has been the case before, but also within a single country with vast land where stages of development greatly vary from region to region—like China. Region-by-region transitions could occur, first affecting the eastern region, then the central region and eventually the western region.

With increasingly low freight costs in the western region and the rising costs of land and labor in the eastern region, the total cost of production may become lower in the west than the east. As a result, labor intensive industries will lose their competitiveness in the eastern region, causing an exodus in search of cheaper land and labor elsewhere. They will be likely to relocate their production bases in the west region where labor and land are still cheap, and the high-speed transportation network will serve as an added advantage. This move will incorporate the western region into the domestic network of division of labor and accelerate the organic integration of the eastern and mid-western economies.

In this connection, it should be noted that the western region will have to compete with other East Asian countries in inviting new businesses. Measures have to be taken to build the investment environment in the western region to encourage more direct investment by foreign and domestic investors.

(4) Overall picture of regional industrial promotion

The industrial development in the West should be based on the inner resourced-based industry as stated in (2) while expecting the chain-affect of the industrialization pattern induced by the abundant labors as sated in (3). Overall, scenarios of industrial promotion should consist of 1) buildup of industries that are firmly rooted in the region and have locational advantages such as industries that utilize regional resources and services and community-oriented businesses with the power to create markets, serving as the basis for the region's industrial structure; 2) on that basis, creation of "footloose" businesses that are lured to the region and venture businesses, and 3) the creation of a complex industrial structure of regional industries as a result from the interactions between 1) and 2).

(5) Development of the west's three large economic corridors

In the western development, three economic zones were selected as priority areas for intensive development, based on (1) fundamental economic conditions; (2) locational advantages; (3) population buildup; (4) availability of major transportation routes, and (5) urban hubs. The strategy maintains that their surrounding areas will benefit from ripple effects. The three large economic corridors of the west; namely the Upper and Central Yellow River Economic Corridor, the Upper Yangtze River Economic Corridor, and the Nanning Guiyang Kunming Economic Corridor; have economic and population bases and urban buildup of global size. Focused development will be made to develop and improve the transportation and urban and industrial infrastructure to urge economic growth as corridors, which will eventually drive growth of the entire western region. By 2050, the three large economic corridors of the western region are expected to have grown into metropolises of international scale.

2.6 Western development and financial system reform

2.6.1 Aspects of promoting western development

This study aims at making policy proposals to clarify what financial system reform should be needed for the promotion of western regional development. However, as is clearly observed, the implementation of financial system reform alone will not result in great advances for the western region. For regional development to accomplish its original objectives, reform and improvements must be carried out in both public and private sectors and on all systems and throughout all operational phases (See Figure 2-5).

Firstly, reform of the economic entities must be made.
For successful western development, each economic entity which plays an important role in economic activity has to undergo further adaptation and transition to a market economy and to redouble efforts in product development, new market expansion, managerial innovation, and personnel development. State-owned enterprises are required to be increasingly independent of the state, which has provided control and protection, and to act like modern enterprises capable of pushing out frontiers on their own. Small and medium enterprises, to which little state help is available in general, need to challenge themselves in the industries with distinctive features by leveraging their creativity and ingenuity and by taking advantage of regional resources. The revitalization of township and village enterprises should be carried out along the same lines. For the agricultural sector, farm management needs to be streamlined through a shift in the types of produce cultivated, raising more agricultural produce for trading, and the expansion of stock farming, and this process must take into account the optimal balance of labor distribution between farming and non-farming endeavors. Of these matters, this study primarily addresses state-owned enterprise reform (industrial revitalization) and agricultural development and promotion.

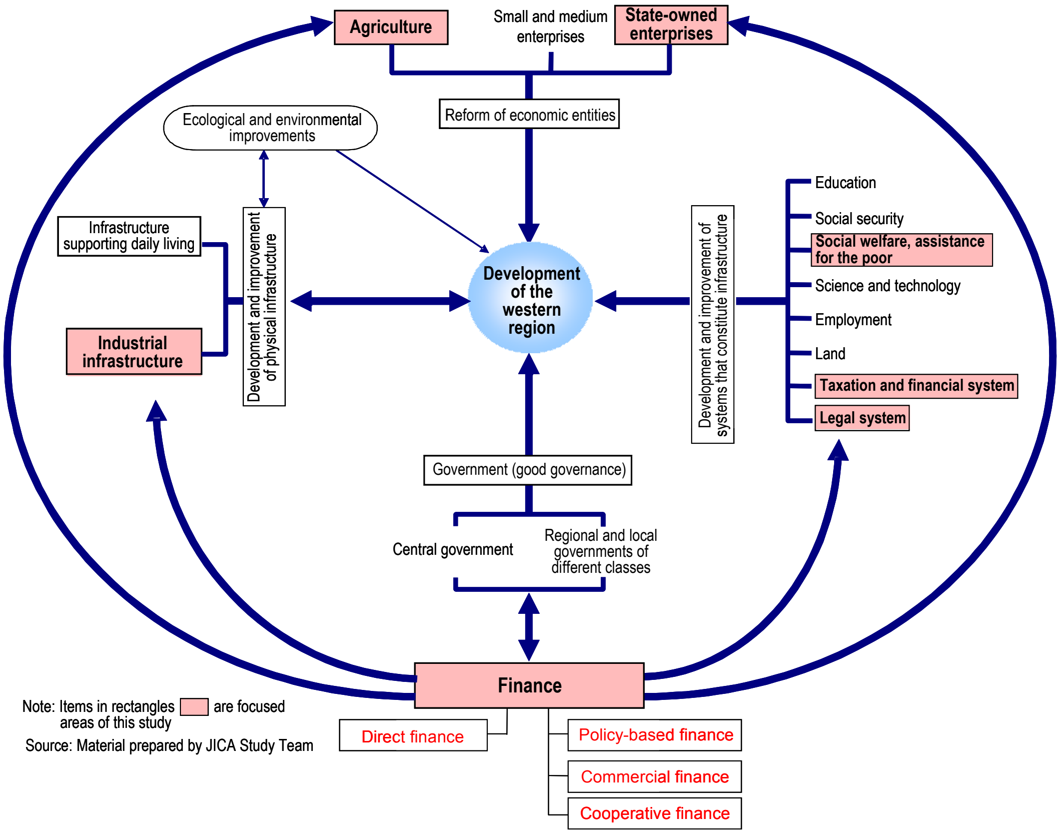


Figure 2-5 Western development and role of finance in the scheme

Secondly, physical infrastructure must be developed.
Physical infrastructure serves as a base for western regional development. Physical infrastructure is largely divided into industrial infrastructure and ones supporting daily living. The former provides foundations for economic development supporting economic growth, while the latter serves as a base for daily living to ensure peace and security for citizens. In developing the western region, it would be essential that optimal developmental balance be achieved between key industrial infrastructure, which functions as the backbone of the land and supports efficient industrial activity, and the infrastructure for daily living, which primarily includes community facilities in urban and rural areas where people maintain their living on the other. Of these elements, this study focuses on the industrial infrastructure as the subject area, for which an overview of the development is presented and analysis of financial resources and ideal financial assistance are discussed.

Thirdly, institutional infrastructure has to be developed.
In recent years, the position of institutional infrastructure as a driver of economic growth has been growing in importance. To accelerate the western region's economic growth, developing institutional infrastructure in parallel with the development of physical infrastructure is crucial.
The documents explaining the policy measures for western regional development state that the introduction of new approaches, new methods, and new mechanisms is important in driving its development. In other words, new institutional infrastructure capable of dealing with new realities and conditions need to be developed for the region.

Principal constituents of institutional infrastructure that supports western regional development are listed in Figure 2-5. Of these constituents, poverty alleviation, finance and taxation systems and investment environment are elaborated in this study, as well as the legal system, which concerns all policy measures. This study does not directly address other spheres of institutional infrastructure such as education. However, systems reform in every sphere is, without doubt, absolutely crucial, since, as stated above, human assets are very decisive and important factors in development.

Fourthly, the role of the government in western development must be addressed.
In any country, the government plays a large role in the development of less developed areas. The western region is no exception. Central and local governments are expected to play important roles in the entire processes, from planning and execution to the evaluation of policy measures.
The key elements here are deliberate guidance by the government and the creation of a regulatory framework that allows economic entities to engage in unrestricted economic activity utilizing the market economy mechanism under the rule of law. Roles of the governments should be redefined, with increased emphasis on planning, formulation, and policy assistance; at the same time, overall control by the governments would have to be reduced to unleash the creativity and ingenuity of the private sector.

As stated before, capital is supplied in accordance with policy measures of the government to fund 1) activities of economic entities 2) development of physical infrastructure, and 3) activities that support educations, poverty reduction, and other initiatives mandated by certain institutional framework. Therefore, institutions and policies addressing specific spheres on one hand and the financial system on the other must undergo mutual adjustments to gradually achieve organic integration.

2.6.2 Role of financial system reform

The success of western development lies in approaches taken to ensure the inflow of funding necessary for development and to create a new mechanism for allowing the funds to circulate while reforming the non-financial issues described above.

Areas with chronic fund surplus and areas with chronic fund deficit may coexist in one country, and yet funds do not necessarily flow from the fund-rich areas to the fund-poor areas automatically since factors that restrain such flows, such as inland locations, low degrees of buildup, and underdeveloped investment environments, are not easy to overcome. Investment returns to be achieved from the western region are likely to remain low for an extended period of time compared with the eastern region.

This may be corrected through the redistribution of public funds. Greater weight of government fund distribution should be placed on the western region where investment returns are low. In the eastern region, where investment returns are higher, private-sector investment should replace public funding for the region's social infrastructure in accordance with the degree of profitability of the investment. Since the launch of the Western Development Strategy, such priority distribution has increased to a considerable degree. A significant share of the state's financial assistance in terms of bond issuance and loans from international organizations and foreign governments has been injected into the western region. However, efforts should be made to seek further allocation of funds through tax reform so that more advanced regions will shoulder an increased tax burden, appropriate to their income, asset, and consumption levels. This could create room for a further increase in public spending for the western region to secure the national minimum.

However, increased public funding alone cannot solve problems. Public funding has its limits and requires prudence and discipline in its use. Therefore, a mechanism that facilitates the flow of funds to the western region has to be built from the combined perspectives of policy-based finance and private finance. This is precisely the aim of this study.

From the macroeconomic point of view, China, with its high saving rate, is a net saver despite its high rate of investment. This is consistent with its current account surplus. Generally, the cumulative buildup of saving is observed in the eastern region. On top of that, a large influx of foreign money is flowing into the eastern region. Therefore, the creation of a system that facilitates the movement of funds from the fund-rich eastern region to the fund-poor western region is essential.

From these perspectives, this study proposes policies for financial system reform through discussions of the mechanism for fund supply, which meets the qualitative and quantitative capital needs of western development, and for facilitating fund flows between regions.

3. Economic Frameworks

This study sets up an economic framework, which shows China's economic and industrial evolution over the next 10 years with a focus on the development of the western region. The economic framework contains regional growth scenarios, which were obtained through the construction of a regional economic model (regional input-output model) as well as scenarios for China's macroeconomic growth.

3.1 Scenario for economic development

3.1.1 China's macroeconomic scenarios

(1) Techniques used to formulate growth scenarios

In middle-range macroeconomic and industrial scenario forecasts, assumptions were made concerning technological progress in the economy over a medium-to-long term horizon (increase in productivity), an increase in population and labor force, and an increase in production facilities (capital stock). Then estimates were made for a variety of endogenous economic variables including potential GDP growth by industrial sector and an increase in GDP components.

The macroeconomic model by industrial sector adopted was an actual general equilibrium model. Specifically, the general equilibrium model and database, developed and made available by Purdue University's GTAP (Global Trade Analysis Project), were used.

The starting point for model simulation was 2001, which is the base year employed by the latest database (Version 6.0). The model simulation was carried out for two time segments. The first segment covered the period from the starting point through 2010 (the final year of the 11th Five-Year Plan) and the second segment covered the period between 2010 and 2015, which is the final year of the 12th Five-Year Plan.

In this study, three scenarios were prepared for China's macroeconomic growth. These are: 1) a basic scenario offering the most likely outcome; 2) an optimistic scenario showing the likely outcome in the event that actual growth conditions turn out to be better than conditions assumed by the basic scenario, and 3) a pessimistic scenario that presents the likely outcome in the event that actual growth conditions turn out to be poorer than conditions assumed by the basic scenario.

(2) Basic macroeconomic growth scenario for the period covered by the 11th Five-Year Plan (2006-2010)

1) Basic scenario

In the basic scenario, the annual average economic growth rate during the period 2005-2010 is assumed to be 7.5 percent, based on the following premises:

- No change will take place in the basic principles calling for liberalization through external opening-up of the economy and deregulation among others, and for developing more sophisticated technology by attracting direct investment.

- Population growth will slow down, but this will be virtually offset by an increase in the labor force participation rate and internal migration of labor (migration of excess labor force from rural areas to cities). No net slowdown in labor growth will be seen.

- The buildup of direct investment and structural adjustments of domestic industries will be carried out smoothly.

- Supply capacity (potential GDP) will grow steadily, not only for the industrial sector but also for the service industry, and aggregate demand that corresponds to potential GDP will be generated domestically and overseas.

- Healthy economic growth will continue in the United States, Japan and Europe, which are China's important trading partners.

- The manufacturing sector, in particular, will benefit from a series of sharp technical advances.

- As per commitment made by China at the time of its entry to WTO, it will proceed with deregulation and allow direct foreign investment in the financial industry and other service industries. The relevant industries will see technological advances as a result.

- The commitment made by China when it joined the WTO will be put into action, and its trading partners will not resort to large-scale market safeguard mechanisms.

- The quotas provided in the North America Multi-Fiber Agreement will be lifted. Conditions for textile exports will greatly improve to benefit China.

2) Pessimistic scenario

The pessimistic scenario is based on the assumption that foreign investment and structural adjustments turn out to be less than expected, with the average growth rate during the period from 2005-2010 of about 5 percent, which is short of the growth rate used in the basic scenario. Additionally, China's inability to sharply increase its exports due to trade and other frictions is assumed by this scenario as a risk factor.

3) Optimistic scenario

The optimistic outlook assumes that the average annual growth rate during the 2005-2010 period would be around 8.5 percent, due to a significantly higher rate of technological progress than envisioned by the basic scenario.

(3) Basic macroeconomic growth scenario for the period covered by the 12th Five-Year Plan (2011-2015)

If the Chinese economy grows according to the basic scenario during the 11th Five-Year Plan period, China will be a nation of medium income by the end of the period, with its income standard twice as high as the 2001 level. In the period of the 12th Five-Year Plan, technological gaps with advanced nations, which make direct investment to China, will narrow, but growth in the labor force is expected to slow down with the full-fledged aging of its population. As a result, potential growth rate of China is likely to drop and remain somewhat suppressed. Furthermore, in light of the growth rate of overseas markets, China is less likely to enjoy the same degree of high export growth it experiences during the 11th Five-Year Plan. Higher aggregate demand will be increasingly brought about by internal rather than external demand.

Based on the above premises, the basic scenario assumes that supply capacity growth (potential growth rate) during the 12th Five-Year Plan period will drop to around 6.5 percent -- the level prevalent among middle-income nations in Asia – and that aggregate demand will be increasingly dominated by internal demand. Technological advances will continue to have strong impact on the manufacturing sector; however, other industrial sectors, including finance and transportation, may also benefit from technological advances. Moreover, service industries will absorb a greater share of the labor force as demand for services grows comparatively faster.

Table 3-1 Economic growth rates assumed by scenarios

(Annual average growth expressed as percentage)

	Basic scenario	Pessimistic scenario	Optimistic scenario
10th Five-Year Plan (Actual and projected) (2001-2005)	8.8 (Based on 2005 forecasts by the World Bank)		
11th Five-Year Plan (2006-2010)	7.5	5.0	8.5
12th Five-Year Plan (2011-2015)	6.5	4.0	7.8
(reference) 2001-2010	8.1	6.7	8.7

Source: JICA Study Team

(4) Premises concerning exogenous variables

In order to conduct a simulation of the basic scenario, the following premises were used for changes in exogenous variables concerning domestic and external economy.

First, total population will grow at an average annual rate of 0.6 percent throughout the period from 2001-2015. The labor force will grow at an average annual rate of 0.9 percent for the period from 2001-2010 and 0.6 percent for the period from 2011-2015.
To determine the rate of technical progress, technological transfer from overseas to be made before 2010 was factored in. The agricultural sector will also enjoy technological progress at an annual rate of around 1.5 percent. These are assumptions for policy purposes. In the mining sector, the petroleum sub sector, which is expected to undertake resource exploitation, will enjoy technological advances at a rate of 4 percent, while technological advances in other sub sectors will be at a rate exceeding 2 percent.

Technological progress at the rate of about 4 to 4.5 percent is assumed for the manufacturing sector, which has benefited from a high level of technological transfer through direct investment since the 1990s. For the automotive sector and sector for other transport machinery (TRN), which are positioned to reap greater benefits from technological transfers from overseas in the wake of China's entry into the WTO, technological advances at the rate of 8 percent are assumed for the former, while 7 percent is assumed for the latter. In the service industry, relatively high rates of technological progress of 7.2 percent (annualized average) and 5.8 percent (ditto) were given to financial services and communication respectively, both of which are expected to reap most technological benefit from technological transfers from overseas.

Technological transfer from overseas is expected to run its course in the period between 2011 and 2015, but endogenous technological progress in the sophisticated end of the manufacturing sector will accelerate rather than decelerate, since the sector will make an increasing shift toward the processing and assembly sector as China's economic reform draws closer to conclusion. Aside from the manufacturing sector, the agricultural sector will experience technological advances induced by improvements in infrastructure and elimination of latent unemployment, and technological advances in the service industry will result from technical transfers and mechanization. Under the pessimistic scenario, which assumes that technological transfers from overseas become difficult to obtain for a variety of reasons, only about one third of the incremental technological advances described above will be achieved. Technological advances under the optimistic scenario on the other hand will be about 150 percent of those achieved under the basic scenario.

3.1.2 China's macro economy and industries in 2015

(1) China's macro economy in 2015 as indicated by the model

We can obtain a total, consistent picture of the would-be economy by introducing, to the sector-by-sector macroeconomic models, the premises used in each of the scenarios, which serve as changes in the exogenous variables in the models, and examining changes in the endogenous variables. The model specification used here is the Baldwin-type dynamic model, which incorporates capital stock as an endogenous variable and assumes that medium-term growth of higher degree is achieved through capital accumulation through technological advances.

Simulation results based on sector-by-sector macroeconomic models are listed in the tables below.

Table 3-2 Real growth rates by GDP component and their respective shares

	Personal consumption	Investment	Government consumption	Exports	Imports	GDP
(Average annual growth rate: %)						
Years 2001-2010	5.6	9.3	6.9	10.4	7.8	8.2
Years 2011-2015	4.1	3.4	6.4	9.3	4.9	6.5
(Share: %)						
2001	42.7	35.3	12.7	33.5	-24.3	100.0
2010	43.5	30.2	12.9	41.6	-28.2	100.0
2015	42.4	29.2	12.8	42.5	-27.7	100.0

(Note) Import is a deduction item.
Source: JICA Study Team

Table 3-3 Future of China's industries (Basic scenario)

	Growth (%)		Percentage (%)		
	2001-2010	2011-2015	Year 2001	Year 2010	Year 2015
1. Grain (GRN)	4.7	5.1	1.25	0.98	0.96
2. Vegetables and Fruits (V_F)	4.0	3.9	3.73	2.91	2.68
3. Livestock (M_D)	5.3	5.6	4.14	3.24	3.23
4. Other agriculture (AGR)	4.4	4.5	2.03	1.56	1.48
5. Coal (COA)	4.1	3.4	0.51	0.31	0.28
6. Petroleum (OIL)	6.3	4.7	0.52	0.54	0.52
7. Gas (MGS)	3.3	4.0	0.02	0.02	0.01
8. Other mining (MIN)	6.4	3.5	1.70	1.29	1.16
9. Processed food (PFD)	4.5	4.2	4.13	3.75	3.51
10. Textile (TXT)	8.6	7.6	5.82	5.36	5.88
11, Apparel (WAP)	10.6	7.8	3.05	2.69	2.97
12. Chemicals (CHM)	7.0	4.4	7.78	8.72	8.24
13. Metals (MTL)	7.0	3.6	10.47	11.07	10.07
14. Automotives(MVH)	8.3	4.1	1.35	1.63	1.52
15. Other transport machinery (TRN)	11.4	5.4	1.28	1.56	1.55
16. Electric machinery (ELE)	12.8	9.5	6.69	6.18	7.41
17. General machinery (OME)	9.4	6.6	9.64	10.29	10.81
18. Other manufacturing (OMF)	7.7	8.7	8.04	7.82	9.02
19. Electricity (ELY)	6.9	4.3	1.18	1.79	1.69
20. Gas production (GAS)	6.6	3.7	0.02	0.04	0.04
21. Water (WAR)	7.5	5.2	0.17	0.18	0.18
22. Construction (CNS)	5.8	-0.7	7.20	7.75	5.70
23. Trade (TRD)	7.6	6.3	6.20	6.40	6.61
24. Marine transportation (WTP)	6.3	5.2	0.25	0.25	0.25
25. Air transportation (ATP)	8.7	7.9	0.21	0.22	0.24
26. Other transportation (OTP)	7.3	6.0	1.94	2.02	2.06
27. Communication (CMN)	7.8	5.7	0.85	0.99	0.99
28. Finance (FIN)	8.6	7.4	1.63	1.89	2.05
29. Enterprise service (OSP)	7.8	6.2	2.37	2.54	2.61
30. Government service (OSG)	7.0	6.5	5.24	5.23	5.46
31. Housing (DWL)	8.9	7.4	0.58	0.77	0.84

Source: JICA Study Team

3.2 Frameworks for the western region's economy and industries through Year 2015

3.2.1 Structure of regional models and simulation methods

The macroeconomic picture obtained by estimation using the method described in the preceding section was divided into several regions, and economic and industrial frameworks that serve the western region of China until 2015 were identified. The regional input-output model, which divides China into several regions, was used primarily, with supplemental use of other economic analyses for population and other matters. For the multi-regional input-output model, we used the 8-region, 30-sector Multi-regional Input-Output Model for China 2000 (base year=2000), which was developed jointly by the State Information Center of China and the Institute of Developing Economies of Japan. Variables that are not considered in input-output models, such as population, labor and relative price fluctuations were estimated based on the basic scenario and through supplementary estimation work carried out separately.

3.2.2 Trends and scenario of the western region's economy in relation to the Chinese economy

Basic scenario for the western development

The basic scenario assumes that both public investment for infrastructure building and private-sector investment including direct investment will accelerate, and total factor productivity will improve as a result of improved agricultural productivity in rural areas and the introduction of processing and assembly manufacturing in urban centers in the western region. This is consistent with the basic principles of western development. The western region's economic growth in real terms during the 11th Five-Year Plan period (2006-2010) will accelerate, albeit at a rate slightly lower than the national average in the beginning of the period, and the rate will eventually catch up with the national average by the end of the period. The subsequent period of the 12th Five-Year Plan (2011-2015) will see further acceleration in economic growth, and we assume a virtual halt on the growing regional disparity in terms of per-capita income. For this, the level of economic growth will have to be in line with the western region's relatively high rate of natural increase in population. However, the migration of labor to the coastal areas is expected to continue, despite some slow down, and the migration-induced decline in the labor force which is not captured by statistics is assumed to be about the same as the natural increase in population. Therefore, the above objective is achievable if the western region's real economic growth is on a par with the national average. Specific growth rates as assumed by the scenario are shown in the table below.

Table 3-4 Real economic growth rates by region as assumed by the basic scenario

	Nation-wide	Western region	Central region	Eastern region
11th Five-Year Plan period (2006 - 2010)	7.50%	10.00%	10.00%	10.75%
12th Five-Year Plan (2011 – 2015)	6.50%	9.50%	9.50%	9.50%
2001 - 2015	--	10.00%	10.00%	10.50%
2006 - 2015	--	9.75%	9.75%	10.00%

(Notes)
1. In Table 3-6, the western region refers to northwest and southwest; the central region refers to the central section, and the eastern region refers to the northeast, northern coastal area, central coastal area, and southern coastal area. See Chart 1of Exhibit 2 in Chapter 3 of *Policy Proposals* for geographical classifications.
2. Three percentage points are added to the regional growth rates since the total of regional growth rates is about 3 percent higher than the nation-based growth rate.

Source: Assumptions by the Study Team

Industry-specific assumptions under the basic scenario include improved productivity for the agricultural sector, which is a leading industry in the western region (and the southwest in particular), a slight outflow of rural population to urban centers, and better developed infrastructure. It is also crucial that urban centers of the western region encourage robust inflows of direct investment and technological advances in assembly manufacturing and service industries, as these are essential requirements.

3.2.3 Economic and industrial frameworks for the western region through 2015

The table below shows annual average growth rates of gross product (output) by industry during the period 2000-2015, which were simulated using the Multi-Regional Input-Output Model.

Table 3-5 Increases in real total product by industry and by region based on the basic scenario (Average annual rate during the period 2000-2015)

(Average annual increase expressed as percentage)

	Northwest	Southwest	Northeast	Beijing Tianjin	Northern Coast	Middle Coast	Southern Coast	Central region
1. Agriculture	4.9	5.3	4.7	2.9	4.8	5.5	6.2	6.1
2. Coal	10.9	11.5	11.5	10.8	14.4	12.3	11.0	13.4
3. Oil	8.4	10.3	7.8	13.7	9.5	36.6	8.3	10.7
4.Other mining	9.1	11.0	12.1	5.8	14.3	12.1	12.4	14.3
5. Processed foods	6.3	5.2	5.2	4.1	6.1	5.9	5.9	7.3
6. Textile	6.1	8.5	8.7	8.8	6.2	7.4	15.6	8.7
7. Apparel	9.3	12.3	10.5	8.1	7.9	11.4	17.1	10.9
8. Chemicals	7.4	8.3	7.6	9.8	10.0	8.5	6.4	11.5
9. Metals	10.0	10.3	11.9	11.6	12.3	10.6	11.4	13.2
10. Transport machinery	8.6	7.4	9.4	13.1	14.0	10.6	16.4	12.9
11. Electric machinery	8.6	8.4	10.8	10.2	12.4	10.6	13.0	9.8
12. General machinery	8.7	8.9	10.9	13.0	13.5	10.0	21.6	11.8
13 Other manufacturing	11.0	10.8	9.1	9.2	9.8	11.8	14.3	12.8
14. Electricity	10.0	10.9	10.1	10.8	14.8	11.6	13.9	14.5
15. Gas production	10.1	13.4	7.9	8.1	16.8	10.0	11.9	11.6
16. Water	12.8	12.8	10.9	10.8	17.0	10.9	15.2	14.8
17. Construction	10.0	9.3	9.6	12.2	11.8	10.0	10.6	11.2
18. Trade	10.2	9.6	10.6	13.2	12.6	12.9	16.1	13.1
19. Transportation	11.6	12.4	13.8	12.8	15.7	16.2	17.5	15.0
20. Service	13.8	15.2	14.0	8.3	16.9	14.9	17.9	16.5

Source: Estimates prepared by the Study Team

Northeast: Heilongjiang, Jilin and Liaoning Provinces; Beijing Tianjin: Beijing and Tianjin Municipalities; Northern Coast: Hebei and Shandong Provinces; Middle Coast: Jiangsu Province, Shanghai Municipality, Zhejiang Province; Southern Coast: Fujian, Guangdong and Hainan Provinces; Central Region: Shanxi, Henan, Anhui, Hubei, Hunan and Jiangxi Provinces; Northwest: Inner Mongolia Autonomous Region, Shaanxi, Ningxia, Gansu and Qinghai Provinces and Xinjiang Uygur Autonomous Region; Southwest: Sichuan Province, Chongqing City, Yunnan, Guizhou and Guangxi Provinces and Tibet Autonomous Region

3.3 Frameworks concerning population and daily living in the Western Region through 2015

The basic scenario calls for annual GDP growth for the western region of 9.75 percent on average for the next 10 years. According to forecasts, the general aging of the population will accelerate across the nation, and a rise in income will lower the birth rate even in rural areas over the long term. Given the latest trend in natural population increase and ignoring population fluctuations associated with migration, per-capita GDP of the western region will grow at a rate of about 9.25 percent per year on average in real terms. In 2003, per-capita GDP for this region stood at RMB6,306 in nominal terms. Per-capita GDP will be RMB18,231 (or US$2200 at the conversion rate of US$1 = RMB 8.277 which prevailed in 2003) in 2015, if it indeed increases at the above rate for 12 years. Per-capita GDP would be even higher if adjusted for its strong purchasing parity. This would roughly equal the 2003 per-capita

GDP of Thailand and is about average among middle-income countries based on World Bank classifications.

The rise in income will be supported by population influx from rural areas to urban centers, as well as by growth of manufacturing and service sectors. It will lead to a decrease in rural population, which in turn will raise per-capita income in rural areas, although agriculture is expected to grow at less than 5 percent per year. To bring this scenario into reality, it is essential that a switch be made from the labor-intensive mode of agriculture, which currently prevails, to a more capital-intensive mode of agriculture through the acquisition of better agricultural technology and, needless to say, through better agricultural infrastructure.

Urban centers of the western region, like their counterparts in the coastal region, are expected to see an influx of labor force. It is important to plan and develop infrastructure for daily living and social welfare in light of the expected influx. Additionally, it should be noted that in order to enable the western region to sustain its growth, urbanization, which is a phenomenon common in advanced and more developed nations, requires the development of intangible infrastructure such as education and labor administration systems, along with physical infrastructure.

4. Estimating Capital Requirements

4.1 Capital requirements: Underlying concepts and estimation methods

4.1.1 Scope of capital requirements

(1) Scope of capital requirements

In this study, capital requirements are defined as the amount of capital needed for long-term formation of fixed assets, which include, among other factors, corporate capital investment, investment in housing, construction of public infrastructure such as industrial infrastructure and public infrastructure for flood control, afforestation, and real estate investment (land development and land improvements, etc). The formation of fixed assets corresponds to "total investment in fixed assets" in Chinese statistics. In this study, attempts were made to estimate the amount needed for this total investment in fixed assets (referred to as 'capital requirements' in this study).

(2) Meaning of capital requirements for the western regional development

The aggregate amount of total investment in fixed assets for the western region (12 provinces and autonomous regions) was estimated, and this amount served as the total of capital requirements for western development. This amount is the total investment amount needed for the western region to perform all of its economic activity.

4.1.2 Estimation methods used for capital requirements

i) Creation of a development scenario and various indexes
The long-term forecasts for macroeconomic and industrial structures (basic scenario), income of the western region of China, and long-term forecasts for industrial structure (basic scenario), which were made available in Chapter 3, were used here.

ii) Estimation of required capital amount
In the western region, the segments and sectors needing capital investment are too extensive for the computation of the aggregate amount of required capital to be invested. Therefore, the real requirements for total investment in fixed assets were computed using the incremental capital output ratio (ICOR) on a macro basis.

For the estimations for the four priority segments, capital requirements for industrial revitalization and agricultural development were computed using the ICOR. For industrial revitalization, total investment in fixed assets was regressed by the net fixed assets amount. This also allowed simultaneous estimation of the disposal rate of fixed capital, and the technique employed was fundamentally identical with the technique using the ICOR. Rural microfinance was estimated based on population forecasts by income group. Estimates for industrial infrastructure were performed based on target rates of completion to be achieved in future.

4.2 Estimated aggregate amount for investment in fixed assets for the western region

Using the regional ICORs, the amount of capital requirements was computed on a fixed-assets investment basis. The ICORs, derived from the respective incremental percentages of real capital stock, estimated from the aggregate amount of total investment in fixed assets, and real GDP for the western region (northwest and southwest sub regions) are compared in Table 4-1 below, based on uniform deflator points in time.

Table 4-1 ICOR estimates

		2001	2002	2003
Northwest subregion	Total of all segments	3.34	3.15	3.37
	Primary industry	3.54	2.72	2.59
	Secondary industry	1.80	1.58	1.80
	Other infrastructure	2.21	2.06	2.03
Southwest subregion	Total of all segments	3.13	2.58	3.21
	Primary industry	1.58	0.85	0.79
	Secondary industry	1.95	1.50	1.69
	Other infrastructure	2.16	1.75	2.21
National Average	Total of all segments	2.51	2.16	2.61
	Primary industry	1.59	1.43	1.90
	Secondary industry	1.66	1.36	1.97
	Other infrastructure	1.57	1.32	1.56

(Note) Estimated ICORs for other infrastructure, which are ICORs in relation to aggregate amount of real GDP, are generally lower than ICORs by industry.
Source: JICA Study Team

Of the actual ICORs for all industries between 2001 and 2003, 3.2 and 2.6 – numbers at the lower end of the range – were assumed for the northwest region and the southwest region respectively in our estimation of investment requirements. Given the basic scenario, which uses the premise that in the period between 2001 and 2015, production will increase at the real GDP growth rate of the western region (9.9 percent for both northwest and southwest), real capital stock will be about four times the level of 2001 (3.8x for northwest and 4.1x for southwest). The capital requirements for the ten-year period between 2006 and 2015 needed to yield such capital stock increments is about RMB21 trillion (2004 price) based on the capital stock disposal rate of 6 percent.

Similarly, total investment requirements for the entire nation for the 2006-2015 period amount to about RMB109 trillion (2004 price) according to our estimates. They suggest that investment directed to the western region will account for about 19 percent of nationwide investment. This level will be practically in line with the degree of priority placed on investment for the western region since 2000, and it implies the necessity of keeping this policy in place for the western development. In 2004, the western region accounted for around 16 percent of national GDP; therefore, future growth of the western region will be driven by investment compared to the national average.

4.3 Estimates by segment

4.3.1 Capital requirements for industrial revitalization

(1) Capital requirement forecast model

In forecasting capital requirements for industrial revitalization, total investment in fixed assets for the secondary industry was estimated on a macro basis.

First, forecasts concerning capital requirements for industrial revitalization were made for the Municipality of Chongqing, one of the cities within the scope of this study, for the period 2004-2015. Then, rough estimates of capital requirements for the entire western region were derived using the estimated proportion of Chongqing City's aggregate investment in fixed assets to the entire region.

(2) Results of forecasts

The investment function with respect to secondary industry in Chongqing based on the actual figures for the period 1990-2003 was calculated as:

amount of fixed assets investment = 0.386211 x nominal GDP - 0.48277 x net value of fixed assets - 0.2922 x total profit tax + 23.12842 (R2 = 0.9676)

Based on this estimation formula, forecasts were made for total fixed assets of all secondary industry. Under the standard scenario, about RMB340 billion for the period 2006-2010 and about RMB630 billion for the period 2011-2015 were forecast as capital requirements needed for industrial revitalization, amounting to about RMB1 trillion in total for the 10-year period. In addition, a scenario of "slower industrial revitalization" and a scenario of "accelerated industrial revitalization" were created to derive capital requirements under each scenario, which deviates by 20 percent (minus for the former and plus for the latter) from the standard depreciation in each year over the term of the period based on fixed asset investment forecasts obtained from the estimation formula of the standard scenario. Forecast capital requirements were about RMB790 billion for the former and about RMB 1.16 trillion for the latter for the 10-year period from 2006-2015.

The above forecast results concerning Chongqing's capital requirements for industrial revitalization were then combined with the estimated weight of Chongqing in aggregate fixed asset investment for the entire western region's secondary industry through 2015 to obtain rough estimates of capital requirements for industrial revitalization for the entire region, which are shown in Table 4-2[3]. Under the standard scenario, required capital for industrial revitalization for 5 years amounts to about RMB3.7 trillion for the period from 2006-2010 and about RMB6.3 trillion for the period from 2011-2015 according to our forecasts.

[3] Chongqing City, being an industrial center of the western region, may experience industrial revitalization at a faster pace than other areas of the western region. Therefore, it should be kept in mind that the possibility of "overstated estimates" exists with respect to the above estimates that concern the entire western region based on the industrial revitalization scenarios of Chongqing City.

Table 4-2 Capital requirements for industrial revitalization (entire western region)

(Unit: RMB 100million)

		2003	2005	2006-2010	2011-2015	Total for 2006-2015
Standard scenario	Investment requirement at final year of the term	3,636	5,740	9,525	15,693	15,693
	Aggregate investment requirement for the period	-	18,857	36,798	63,421	100,220
Scenario of slower industrial revitalization	Investment requirement at final year of the term	3,636	4,766	7,743	12,658	12,658
	Aggregate investment requirements for the period	-	17,312	30,093	51,287	81,380
Scenario of accelerated industrial revitalization	Investment requirement at final year of the term	3,636	6,727	11,297	18,729	18,729
	Aggregate investment requirements for the period	-	20,403	43,504	75,564	119,068

Source: JICA Study Team

4.3.2 Capital requirements for agricultural development

(1) Capital requirement forecast model

In forecasting capital requirements for agricultural development, the incremental capital output ratio (ICOR) for the past was computed first using capital stock of the primary industry in the western region as a base, and scenarios for future ICOR were created based on it. Next, the amount of investment in fixed assets needed to reach the forecast real production for the primary industry derived from the economic model was computed for each of the three scenarios.

(2) Results of estimates

The ICORs for the primary industry in the western region for the period 2001-2003 were computed as follows.

Table 4-3 Incremental capital output ratios (ICORs) of primary industry

Year	Northwestern subregion	Southwestern subregion
2001	3.54	1.58
2002	2.72	0.85
2003	2.59	0.79

Source: JICA Study Team

In estimating capital requirements, the ICORs of the most recent three years are used based on the assumption that the government will fundamentally keep intact its policy of assisting agricultural development in the western region. The ICOR of 2.6 – the lowest ICOR in the 2001-2003 period, was selected for the standard case with respect to the northwest sub region, whose ICORs stayed generally higher over the period. For the southwest sub region, the ICOR of 1.6, the highest ICOR for the period, was selected for the standard case. Additionally, 2.0 and 1.2 were selected for the northwest and southwest subregions respectively for the case with lower investment, and 3.0 and 2.0 for the case with higher investment.

Based on the forecasts derived from the economic model, the growth rates of the primary industry for the period 2006-2015 were assumed to be 4.9 percent for the northwest subregion and 5.3 percent for the southwest subregion. The amount of investment in fixed assets was calculated in achieving the growth rates for each of the cases with varied ICORs (See Table 4-4). The forecast results for capital requirements show that the capital required for agricultural development in the western region in the decade from 2006 to 2015 is estimated to be between RMB850 billion and RMB1,280 billion (2004 price).

Table 4-4 Estimated capital requirements for primary industry in the western region (2004 price)

(Unit: RMB 100 million)

	ICOR		
	Case with lower investment (Northwest: 2.0; Southweset:1.2)	Standard case (Northwest: 2.6; Southwest:1.6)	Case with higher investment (Northwest: 3.0; Southwest: 2.0)
2005	583	727	852
2006-2010 (Cumulative)	3,594	4,530	5,340
2011-2015 (Cumulative)	4,955	6,326	7,514
2006-2015 (Cumulative)	8,549	10,856	12,854

Source: JICA Study Team

4.3.3 Capital requirement for agricultural microfinance

(1) Method of estimation

Firstly, an income distribution model (Lorenz Curve) for the rural areas in 2004 was prepared to determine the eligibility of household groups and their income levels for micro financial borrowing. Secondly, based on this income distribution model and estimated per-capita GRDP assumed in the macroeconomic model, a per-capita net income distribution model up to 2015 was prepared. Finally, the amounts of loan requirements corresponding to the levels of per-capita net income were estimated from the regression model, which was obtained from the survey results.

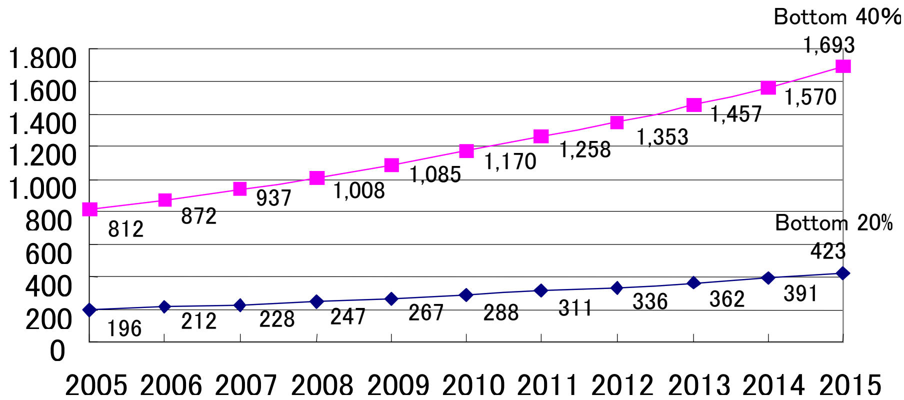
$$y = -46.09572801 + 0.849366207x$$

(Where: y = Annual borrowing per person; x = Annual net income per person)

(2) Results of estimates

Following the above method, the amounts of capital required for rural microfinance in the western region through 2015 were calculated and are shown in Figure 4-1. Demand for microfinance by the bottom 20 percent of all households (low-income and absolute poverty groups) in terms of annual net income as of 2015 was estimated to be RMB42.3 billion in total while demand by the bottom 40 percent was estimated to be RMB169.3 billion in the western region.

(Unit: RMB 100 million)



Source: JICA Study Team

Figure 4-1 Capital required for rural microfinance in the western region (2005 price)

4.3.4 Capital requirements for the development of industrial infrastructure

Given the difficulties in obtaining data for private-sector capital stock sorted by segment of industrial infrastructure and in light of the necessity of accurate estimate for capital requirements for each segment of industrial structure, estimates were performed using the buildup technique based on the development plans released by the authorities for each segment of infrastructure.

The estimates were prepared with the government plans' targets for development completion rates as the base; therefore, it should be noted that 1) any incremental capital requirements for additional plans to be set up later for infrastructure development are not reflected in the figures; and 2) small and medium-scale projects that are not described in the development plans are not reflected in the figures except for road-related projects.

Table 4-5 Capital requirements for industrial infrastructure of the western region

(Unit: RMB 100 million)

	2006-2010	2011-2015	2006-2015
Railway	3,650	2,350	6,000
Road	3,880	2,020	5,900
Airport	75	75	150
West-to-East Natural Gas Transmission	90	2,610	2,700
West-to-East Power Transmission	1,200	400	1,600
Water supply	250	250	500
Power generation	1,200	2,000	3,200
Total	10,345	9,705	20,050

4.4 Concluding remarks on estimates

Capital required for the western development is about RMB21 trillion (2004 price) in total as shown in Table 4-6. The largest proportion of funds is for industrial revitalization. This is quite appropriate in light of the relatively high proportion of capital stock of secondary industry (about 40 percent). Meanwhile, agricultural development and rural microfinance do not account for large proportions. This is explained by low capital and production percentages (about 5%) and the relatively low growth rate of primary industry. Fund requirements for the development of industrial infrastructure take into consideration only priority projects, but industrial infrastructure still claims about 10 percent of the total capital requirement. This suggests the importance placed on large-scale development projects for industrial structure in the entire western region investment.

The investment to the above four priority areas accounts for about 60 percent of total fund requirements for investment. The balance is directed to areas other than the four priority areas such as investment in small and medium-scale infrastructure and investment directed to tertiary industry.

Table 4-6 Capital requirement for the western region(Total amount for the period 2006-2015)

(Unit: trillion RMB)

	Capital requirement amount	Percentage against total
Total amount of investment in fixed assets	20.90	100.00%
Total investment for the four priority areas		
Industrial revitalization	10.02	47.90%
Agricultural development	1.09	5.20%
Rural microfinance	0.17	0.81%
Industrial infrastructure	2.01	9.61%

Source: JICA Study Team

5. Basic direction for financial system reform with respect to western development

5.1 Issues to be solved for financial system reform: from perspectives of capital requirements

In Chapter 4, we estimated total investment in fixed assets for the 10-year period between 2006 and 2015 to be RMB 21trillion (2004 price). Given that in 2003 total investment in fixed assets was RMB 1.1 trillion, the estimate implies that a high level of investment in fixed assets needs to be maintained for the western region to sustain high growth.

5.1.1 Current state of capital supply in the western region

The following characteristics are observed in the current state of capital supply in the western region:

(1) Investment in the western region accounts for about 20 percent of the nationwide figure.
(2) There are signs that investment growth is slowing down in the region on a relative basis.
(3) Investment in the western region is more reliant on national budget.
(4) There are signs that the weight of domestic borrowing is increasing.
(5) The percentage of foreign investment is small.
(6) The percentage of state-owned economic entities is relatively high among the investment entities.
(7) Investment for resource development and infrastructure development accounts for a relatively large portion.
(8) The size of investment varies greatly by province

5.1.2 Issues to be solved for financial system reform

In light of the current state of investment in fixed assets in the western region, the following issues need to be addressed to ensure a stable supply of funds in the next decade to meet capital demand of the region on a continuing basis.

(1) Increase in fund supply through financial markets
(2) Stronger banking sector
(3) Fostering capital markets
(4) Fostering non-bank financial institutes
(5) Boosting corporations' ability to raise capital on their own
(6) Increased capital to be injected to non-state-owned enterprises
(7) Effective utilization of governmental money
(8) Encouraging robust foreign investment

5.2 Basic directions for financial system reform with respect to western development

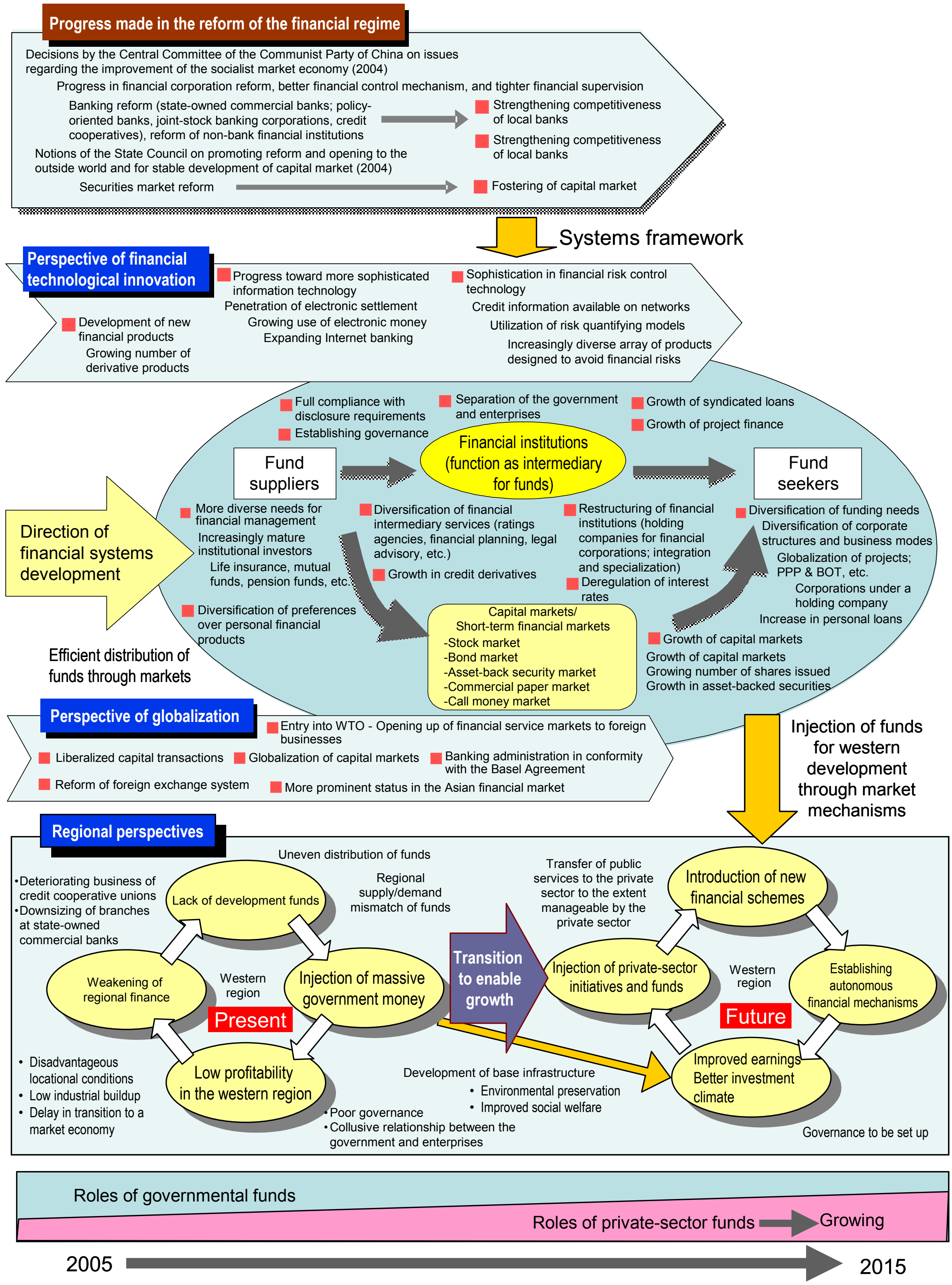
5.2.1 Trends in China's financial system reform – Coping with issues from three perspectives

Currently, China is undertaking financial system reform. With scheduled financial liberalization, radical all-round reform is called for with respect to the financial system, which is at a major turning point. In examining basic directions to be taken on the financial reform front in connection with western development, whose time horizons stretch as far as 2015, it is above all essential to understand the environment that surrounds China's finance and to fully visualize the state of financial systems that such reform aims to realize.

Based on the assumption that the Chinese government is carrying out its financial reform in the directions outlined above, the future direction of financial reform for western regional development can be visualized from the following three perspectives:

(1) Perspective of globalization
(2) Perspective of innovation in financial technology
(3) Regional perspective

Results are indicated in Figure 5-5.



Source: JICA Study Team

Figure 5-1 Three perspectives for the financing of the western region

5.2.2 Basic principles behind the designing of financial system for western regional development

In this study, a financial system for western regional development was designed in accordance with the following basic principles:

(1) Emphasis on a new mechanism for fund inflows

For the western region to sustain its development on a continuing basis, the creation of a new mechanism that facilitates inter-regional fund flows and encourages inflows of developmental funds into the western region to meet its capital requirements is essential. In the long term, it is important that the region gradually remove itself from its reliance on government money and turn increasingly to capital markets for its funding needs. Therefore, the development of capital markets and an increase in incoming funds through the capital markets will be critical in this process.

(2) Need to set up a financial policy for western regional development that is in harmony with the nationwide macroeconomic financial policy

To ensure a stable supply of the funds needed for western development, the creation of a financial market mechanism that allows efficient distribution of funds for the entire nation, the establishment of governance and removal of moral hazards, and the formulation and execution of sound macroeconomic policies are required. These elements must be accompanied by better coherence with financial policies aimed at stable and sustainable economic development and the prevention of financial risks so that better control over capital requirements will be in place for development of the region.

(3) Clarification of roles played by the government and non-government sector

China is undergoing a rapid transition to a market economy. In the long term, economic activity will primarily be carried out through the market mechanism, and the government should shift its role in complementing the market mechanism to ensure its proper function. Accordingly, for financing of western regional development, a shift in primary focus should be made toward funding through market mechanisms. It is desirable that government funding becomes subordinate to market funding.

(4) Optimization of funds supplied by the government

At this point, government funds play an important role in western development. Local governments, with a lack of adequate sources of funds, are in financial distress. In particular, governments at county level and below are seriously strapped. The role to be played by the government is to ensure the national minimum for its citizens. However, it is difficult to achieve national minimum standards for public service such as education and medical care in the situations that prevail now. Therefore, financial reform should be placed on the agenda to allow local governments to run and manage their own finances. To this end, the downsizing of the public administration to achieve greater efficiency, combined with the optimal allocation of tax revenues to the central and municipal governments will have to be achieved. As part of these efforts, transfer to the private sector of public service programs that the government does not have to provide itself should be considered, and this may be done by consolidating programs into those that need to be run by the government and those that may be transferred to the private sector.

(5) Examination of financial policies designed to encourage development driven primarily by the private sector

Over the medium-to-long term, certain roles played by the government in western development need to be transferred to the private sector. One underlying reason for this is that private capital has to assume the pivotal role in economic development under the market economy. The other reason is that certain restrictions are imposed on the government's ability to supply capital. Thus, financial measures that encourage inflows of private capital should be examined through promoting investment from the east-based companies into the western region and mergers and acquisitions of businesses in the region.

(6) Establishing environment to facilitate an autonomous system of fund circulation within the region

The long-term objective for sustainable development in the west relies on creation of an autonomous mechanism for fund circulation based on market principles. The environment must be developed and primed from the following perspectives.

(7) Enhancing fund seekers' ability to raise funds

For the smooth operation of the financial system, borrowers need to satisfy loan requirements. Borrowers for regional development are quite diverse in terms of funding channels and project types, which range from corporations engaged in large-scale infrastructure investment and state-owned enterprises of varied size, to private corporations and farmers. They must fulfill eligibility requirements, which concern profitability, business management ability, financial resources, and financial and fund management abilities, in order to receive loans or investment.

(8) Raising fund suppliers' ability to supply funds

Of the factors that impede the smooth flow of funds in financing western development, the following are attributable to fund suppliers and financial institutions in particular:

- Expansion of policy-based finance
- Review of the roles played by state-owned commercial banks in regional finance
- PPP (public-private partnership)
- Stronger abilities to deal with new financial schemes such as project finance
- Reconstruction of weak local financial institutions and expansion of regional finance
- Securing of managerial autonomy for financial institutions
- Securing of governance and transparency of financial institutions
- Better skills and abilities possessed by workers in the financial industry
- Better control abilities against financial risks
- Creation and improvement of a legal system that allows a better business environment for financial institutions

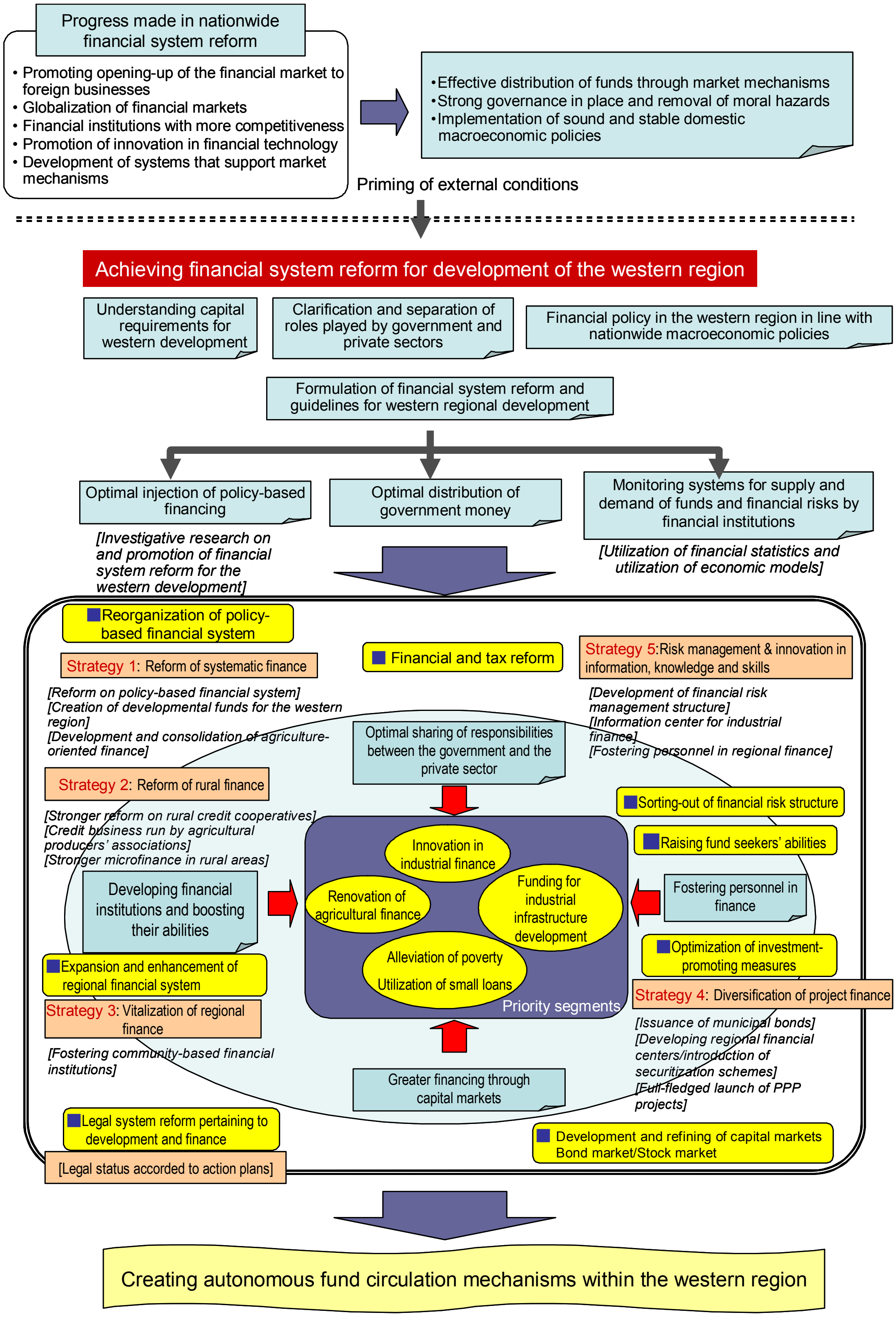
(9) Establishing a financial system that functions properly for western regional development

In reforming the financial system for regional development, the utmost attention should be paid to the efficiency and effectiveness of the overall system to be built. The financial system should be one that serves development of the region most effectively and that completely fulfills overall funding requirements for the entire development. In this connection, it should be noted that existing resources and organizations available at financial institutions in China must be utilized effectively.

(10) Prevention of moral hazards

One structural issue faced by China is the pervasive problem of moral hazards in organizations. Numerous moral hazards in conjunction with corporate lending, IPOs, government outlays, and other financial fields have been reported. In carrying out financial system reform for the western development, ample caution should be paid to prevent moral hazards in connection with the new financial schemes.

In Chapters 6 through 17 below, the overall structure of financial and related system reform will be sorted out by detail. In Chapters 18 through 20, strategic action plans for financial system reform in connection with western development will be outlined. Our recommendations relating to financial system reform for regional development are summarized in Figure 5-2 to provide an overview of the reform.



Source: JICA Study Team

Figure 5-2 Overview of our proposals concerning financial system reform for western regional development

5.2.3 Responses by implementation stage

The ten-year period this study intends to focus on (2006-2015) is divided into three large stages. Major policy challenges which, in our opinion, surface at each stage are summarized in Table 5-1.

Table 5-1 Issues relating to the financial system western development

Stage	Major issues
Stage I (2006): Solutions to short-term, urgent issues	・Examination and formulation of basic policies relating to the financing of western regional development ・Introduction of measures to cope with urgent issues. ・Execution of already formulated financial reform ・How to cope with funding needs relating to short-term developmental issues
Stage II (2007-2010): Solutions to medium-term policy challenges	・Creation of a financial mechanism based on market principles ・Introduction of new financial schemes ・Reform of financial institutions of different types and strengthening of their competitiveness ・Transparency to be secured in connection with the financing of western regional development and removal of moral hazards ・Ways to cope with globalization has to be found
Stage III (2011-2015): Solutions to long-term policy challenges	・Diverse funding channels to be in place to finance western regional development under increasing globalization and liberalization ・An autonomous fund circulation mechanism to be in place

Source: JICA Study Team

II. Challenges concerning development of priority areas and reform of fund supply system

II Challenges Concerning Development of Priority Areas and Reform of Fund Supply System

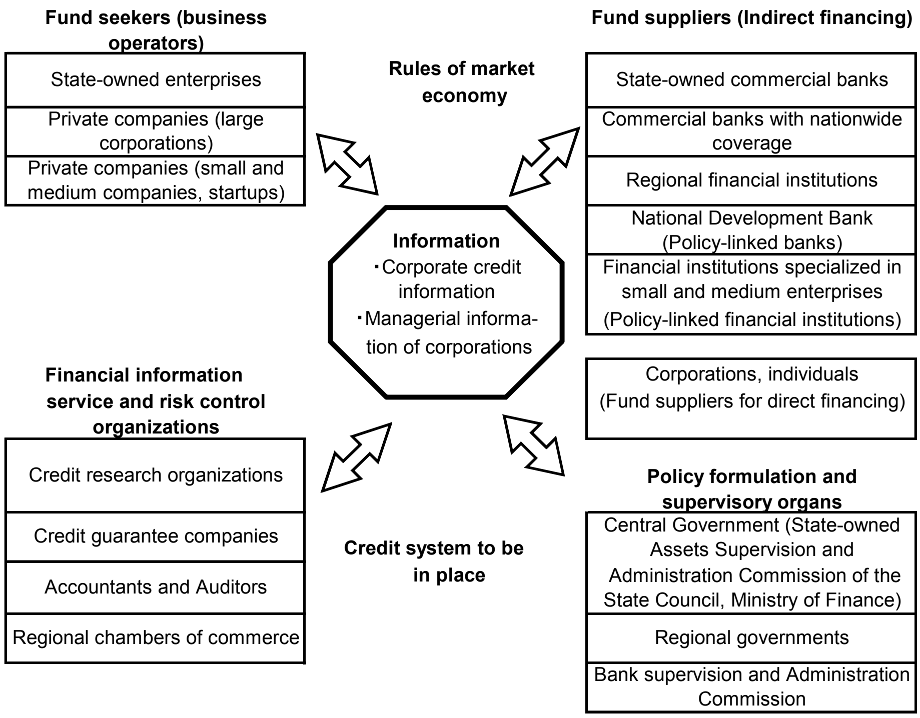
6. Industrial revitalization (state-owned enterprise reform) and innovation in industrial finance

6.1 Basic direction of innovation in industrial finance

The direction in bringing innovation to industrial finance in the western region should be characterized by its efforts to build efficient, mature, and highly transparent relationships among the key players of the financial markets including the government, business operators (state-owned and private companies), and financial institutions (policy-based banks, state-owned commercial banks, private commercial banks, regional financial institutions) based on management and credit information of corporations.

To achieve this, the funds directly injected into state-owned enterprises by the government must be reduced. After the roles of players and their interrelationships in the market economy are redefined, measures to increase transparency and marketability of business activity and of financial control of both business operators and financial institutions need to be in place through the utilization of management and credit information of corporations. "Flexible financial intermediary functions in the market economy", which meet the needs of industrial revitalization and a wide range of needs for industrial funding must be strengthened so that industrial financing will no longer have to rely heavily on public financing (reliance on government), and a genuine transition to a financially functional system will be made.

In achieving the above, regional governments, which have had a large say in the financing of state-owned enterprises, should present policies and guidelines designed to address the following issues regarding industrial revitalization of the western region. They should relegate decision-making concerning personal loans to the rules of the market and no longer make direct decisions or guidance on such matters.



Source: JICA Study Team

Figure 6-1 New interrelationships among players in industrial financial market

6.2 Stronger planning and information-generation functions in industrial finance

6.2.1 Creating a team of professionals specialized in industrial finance

Financial institutions, which play a central role in supplying funds, need to build a team of professionals specialized in industrial finance, who can assess individual loan cases properly based on analysis of medium-range supply and demand outlook of industrial funds, combined with insight into the competitive environment on domestic and overseas fronts, supply and demand of major products, and trends in technologies and equipment. It is crucial to build organizational capabilities relating to industrial finance and nurture specialists in industrial finance who are adept at evaluating customers' competitiveness, technological strength, and profitability, conducting credit analyses, risk assessments, ALM (Asset-Liability Management) and risk control, and developing new financial schemes.

6.2.2 Studies on corporate finance and capital investment

Chinese corporations in the western region, to which the modern corporate system was introduced only recently, lag behind in establishing filing and disclosure systems for accounting and financial information. For this reason, stronger governmental supervision and instructions pertaining to the accounting standards based on the Company Law alone would be insufficient; financial institutions and especially those that serve as major partner banks of enterprises need to educate their corporate customers in processing financial and accounting matters while collecting, accumulating, and sharing information on customers' financial and capital investment status.

China Development Bank should take a lead in annual regional surveys, both in provinces and in hub cities, on financial and business investment plans of enterprises targeting at both leading enterprises on and small and medium enterprises. The surveys intend to compile and consolidate information on financial and investment plans of enterprises including those state-owned. In addition, regional financial institutions should undertake similar surveys targeting local firms which are mostly small and medium in size.

6.2.3 Creation of information center for industrial finance and corporate information database

It is desirable that an extensive and versatile database of corporate credit information, which will be based on data obtained by financial institutions through their independent studies and on data supplied by credit research agencies, should be built and implemented in several phases. One way of accomplishing this is through the formation and running of a regional "information center for industrial finance," which is to be funded and created jointly by financial institutions along with regional governments and local chambers of commerce. In addition, an extensive and highly versatile database containing corporate information should be prepared based on the data contained in corporate credit information databases, other existing information, and newly-acquired and accumulated information about management, finance and capital investment of corporations in an attempt to build and organize highly-reliable information.

6.2.4 Creation of a group tasked with the formulation of medium-to-long term outlook

Financial institutions in each region are recommended to form a group, which develops medium-to-long term outlook on industrial funding, encourages information sharing, and expands knowledge relating to the supply and demand of industrial finance. In this process, China Development Bank, linked to specific policy objectives, should take an active role in the formation of a platform where corporations and financial institutions can exchange information and opinions on short and medium term requirements for industrial financing including the volume and the details.

6.3 Efforts by policy-based banks to accord high priority to industrial finance

It is desirable for systems to be designed to ensure proper division of roles and coordination between policy-based financing and commercial financing, so that they will function together as an effective fund-supply mechanism. To be more specific, the fields and business projects that fall under the scope of policy-based financing administered by China Development Bank and consistent with the western region's short and medium-term strategies on economic growth, industrial revitalization, structural adjustment, and state-owned enterprise reform should be identified. Then such policy-based financing should exert pump priming effects by strengthening the leading role of China Development Bank in co-financing with commercial banks aiming at smooth supplies of industrial capital.

China Development Bank needs to examine the prospect of new loan programs and other incentives to address three areas: structural reforms (disposal, integration, or discontinuation of unprofitable business) of medium and large state-owned enterprises in order to boost the attractiveness of the western region as a place of investment; strengthening priority and new businesses; and environmental measures and energy and resource conservation. Specifically, loan schemes are proposed to be set up for "investments for priority industry and new business creation", "investment for the environment and improvements in resource and energy efficiency", and "structural adjustment loans for the promotion of plant disposal of plants and equipment". Preferential interest rates and repayment periods should be available for them on a limited-term basis (three to five years).

6.4 State-owned commercial banks' shift to industrial financing

Based on market principles, state-owned commercial banks will be required to render their own version of industrial financial services to a broader range of business operators including privately run companies by taking advantage of more accurate business and credit information. Measures that may be taken in the western region to facilitate a shift to industrial financial loans are listed below.

(1) Each bank should have a clear idea about the position assumed by industrial financing in its own business portfolio based on its characteristics and strengths in business base and types of services.

(2) Organization and personnel engaged in industrial finance should be strengthened and fostered. Close informational exchanges and sharing with corporations (fund seekers) should be made. More loans in cooperation with policy-based banks should be extended such as coordinated loans with policy-based banks, loans extended in lieu of policy-based banks, and loans that supplement existing loans extended by policy-based banks.

(3) When extending coordinated loans with policy-based banks or providing incremental loans to existing loans, three areas should receive priority; i.e. investments for prioritized and new businesses; environmental measures and improved resource and energy efficiency; and structural reform for promoting plant and equipment disposal.

(4) Loans to state-owned enterprises, which have been their standing customers, should be made on a selective basis, and more loans should be extended to private and small and medium enterprises, which may have some risks but with outstanding earning potential.

6.5 Regional financial institutions' undertaking to strengthen industrial financing functions

In the western region, former urban credit cooperatives were transformed, through integration and reorganization, into city commercial banks and other regional financial institutions, which are expected to perform community-oriented financial functions. Meanwhile, city commercial banks largely assume the character of a state-owned commercial bank under the jurisdiction of the regional government. The regional government limits the number of branches and the scope of services offered by such banks in each of the provinces and in major cities. As a result, they are not positioned to offer flexible services to fully meet regional financial needs. Looking ahead, it is crucial for regional financial institutions, including city commercial banks, to boost their lending abilities through the development of a greater variety of financial products and guarantee schemes to meet the needs of locally-based small and medium enterprises and medium-sized leading enterprises. At the same time, skill enhancement of personnel is necessary through day-to-day lending activities and greater interaction with locally-based companies and entrepreneurs to whom advice on business management is to be dispensed and loans are extended. In addition, there should be a parallel review of the regulations pertaining to opening and the scope of services imposed on the regional financial institutions so that they can raise funds from broader sources and expand their funding ability.

6.6 Reform of financial system for small and medium enterprises

Many issues must be solved in order for small and medium enterprises to gain better access to funds available at banks. These include:

- Delayed modernization of business and managerial culture at many private companies, primarily small and medium enterprises
- Lack of adequate security or collateral
- Higher costs of transactions associated with small-scale loans
- Interest rate structure that does not account for risk factors
- Lack of financial institutions specialized in serving small and medium enterprises

In order to ensure the supply of appropriate funds to former state-owned small and medium enterprises that underwent privatization and privately-run small and medium enterprises on autonomous basis, a financial system should be designed including fostering of community-oriented small and medium financial institutions, which meet regional needs as well as specific funding needs of customers of different sizes. Measures to strengthen functions of the local financial institutions in the western region include: (1) creation of policy-based financial institutions dedicated to small and medium enterprises; (2) reform of credit guarantee system; and (3) transfer functions conducted in branch and sub-branch of state-owned commercial to regional financial institutions that are best versed in local conditions.

6.7 Development of systems and environment that support innovation in industrial finance

(1) Consolidation and streamlining of roles played by public finance and development of legal foundations

For smooth running of industrial financing, it is important that the medium and long-term objectives and specific assistance measures relating to industrial revitalization and structural adjustments be spelled out in legislation and implementation of laws. If clearer definitions are given to the roles played by the government and by public finance in industrial revitalization of the region, and if medium-term outlook on industrial structural adjustments is presented articulately, policy-based financing and governmental assistant measures, which act as a catalyst to attract commercial financing, will unleash greater complementary effects[4]. One proposal in this connection is that Regulation for Industrial Restructuring in the Western Region (tentative name) may be drafted and implemented. The Regulation is to stipulate specific actions to be carried out under the Basic Law on Regional Development (tentative name) and Western Development Regulation (tentative name), whose enactment is pending. If specific measures

[4] In Japan, industrial structural adjustments, plant/equipment disposal and relocation in select regions, and environmental measures were carried out in accordance with the Industrial Relocation Promotion Law and the Law Promoting Regional Development of Sophisticated Technology and Industrial Buildup (Technopolis Law).

pertaining to industrial revitalization and industrial structural adjustments are to be implemented by laws, proper coordination should be sought between financial measures and fiscal measures such as interest subsidies and tax breaks at the time of capital investment and disposals.

(2) Development of various funds

In order to diversify funding sources available to enterprises in the western region, a variety of investment funds with specific objectives should be set up such as entrepreneur support funds, industrial revitalization funds, and hi-tech development funds. Through the creation and management of the funds that are backed by professionals with abilities to analyze and evaluate risks and profitability, money in the western region should be absorbed into these funds and channeled to growth fields, thus allowing greater circulation of industrial funds.

(3) Better administration of finance and accounting-related matters in businesses, combined with better transparency

The largest challenge in industrial financial innovation is for the fund seekers to boost their abilities to obtain funds through developing proper financial and accounting-related practices and increasing transparency of their business. For state-owned enterprises, in particular, it is essential to establish a modern corporate system in which managerial and decision-making mechanisms operate in a sound and transparent manner. Strict compliance with Company Law and introduction of appropriate financial and accounting systems would be the first step in this direction. Also, it is important for enterprises to raise their capacities through developing financial and managerial specialists as this would help them discuss investment and financial strategies on an equal footing with fund suppliers and allow more effective and positive presentations of their investment and financial plans to financial and capital markets.

(4) Functions of nurturing and assisting entrepreneurs to be strengthened

While industrial revitalization and structural adjustment are progressed, business activity by new entrepreneurs shall assume greater importance, and stronger and enhanced assistance geared to the fostering of entrepreneurs would be desired. In addition, a mechanism would be needed to provide low-cost business advisory service (BAS) to micro, small, and medium enterprises including one-stop inquiry desk handling all matters relating to how to start a company, consultation and practical assistance by advisors, financial assistance for start-up and working capital, and consultation relating to managerial practice for companies in the post-startup stage. Such services geared to micro, small, and medium enterprises including financial assistance programs for the fostering of entrepreneurs would be ideally planned and run in cooperation with policy-based financial institutions specialized in small and medium enterprises and local chambers of commerce.

(5) Development of capital markets and lifting of some requirements for IPO

In addition to measures to bring overall improvements to Chinese capital markets, discussions should be made concerning the possibility of partial waiving of IPO requirements, which are applied across the nation now, for some select enterprises in the western region with high growth potential. Other options that might be discussed include the generation and channeling of funds needed by the western region within the region through establishing a stock exchange run specifically for the western region (Section II regional stock exchange).

(6) Utilization of idle funds in the region through private placement

A private placement is a type of corporate bond issued to a limited number of investors and individuals. It works as a powerful tool for corporations trying to raise long-term funds. Private placements as an alternative to corporate bonds, whose issuance is not practically feasible for companies in the western region, should warrant special attention, and a community-based mechanism of issuing and circulating private placements may be custom-made to suit the western region.

(7) Fostering of financial professionals and business schools for the western region

Financial institutions have to revamp their knowledge about the competitive climate, supply and demand balance of main products, and technological and investment trends in each industrial sector. At the same time, they need to redouble their effort to develop highly skilled professionals capable of performing credit analyses and risk assessments of customers, administering stronger ALM and risk control, and developing new industrial financial schemes.

For the effective development of financial professionals in the western region, we propose that a financial business school for the western region is created and operated in some financial center in the western region, where practical and pragmatic know-how is to be taught in cooperation with financial institutions, relevant departments, and business schools affiliated with universities.

7. Agricultural Development and Innovation in Agricultural Finance

7.1 Basic approach to innovation in agricultural finance

7.1.1 Overcoming funding constraints

Low profitability of agricultural production, combined with high risks associated with natural disasters and price fluctuations, could serve as an important fund-constraining factor. In the western region of China, a delay in modernization and vulnerability of its ecosystem and the environment exacerbate these problems, and the subsistence level of agricultural production coupled with a delay in the formation of human assets reduces the creditworthiness of farmers even further, making it increasingly difficult for them to obtain funding. Credit checks, which are required on account of the dispersion of farmers and the impossibility of using their real estate as collateral, result in higher lending costs. The high costs and high risks of agricultural lending have led to a massive outflow of rural deposits. The injection of public funds into agriculture and rural areas is low, and a delay in the development of distribution and management system for funding in rural areas hinders efficient utilization of public funds.

In order to boost the income level of the rural population in the western region on a sustainable basis, structural adjustments affecting the agricultural sector and ultimately the entire rural economy have to be made, but to accomplish this, more capital supply must be made available first and foremost. Individual measures to be considered first should include measures designed to promote increased channeling of rural deposits, especially of postal deposits, and an increase in financial assistance by the government. In parallel, innovation in rural financial systems that help reduce funding constraints faced by farmers needs to be implemented.

7.1.2 Clarification of scopes that fall on public finance and commercial finance

(1) Roles of public finance in agriculture

In China, public assistance has not been directed to the agricultural sector on a significant scale. The roles that public finance should play in this sector are listed below in three groups.

1) Expenditure on public and semi-public assets
Comprehensive agricultural development is needed of small-scale facilities that serve as agricultural infrastructure and of infrastructure for rural living including local expressways and agricultural roads, water system, elementary and middle schools, and public healthcare centers. Funds for these projects do not necessarily come from public finance. If an appropriate operating entity is to be set up, the capital required for the creation of this company may be funded by the government while the remaining capital requirement may be raised by equity participation by beneficiaries and/or borrowings from financial

institutions.

2) Research and development in agricultural technology and its dissemination
Specifically, the launch of and activities by agricultural research institutes and the faculty of agriculture in universities should be supported. The construction of related facilities would be funded by public finance and borrowings. Operational expenses would largely be borne by public finance.

3) Assistance for agricultural development
Assistance would largely be in the form of subsidies for agricultural equipment and facilities owned by the private sector. Other options might include reimbursement by the government to policy-based financial institutions offering preferential interest rates for policy-based loans in the event of any negative spread between the lending rate and incurring costs.

(2) Functions of lending activities in the agricultural sector

Lending in China's agriculture and rural villages is immature and lags behind. Until recently, very little systematic finance was provided to agriculture due to low productivity and high risks associated with unstable volume of the crops raised, except for a limited number of small-scale loans extended by Rural Credit Cooperatives to individual farmers. Farmers often find it difficult to borrow money for agricultural production from formal sources such as legitimate financial institutions and are forced to rely on "informal" lenders as a source of funds. As it stands now, no system for the execution of policy-based finance including aids for comprehensive agricultural development and for the development of agricultural infrastructure is available. In light of growing concern over the scarcity of public finance, a greater role would have to be assumed by agricultural finance, which should be tapped to compensate for the lack of public funds. For these reasons, a comprehensive financial system for the agriculture sector needs to be built as quickly as possible.

(3) Identification of scopes that fall under policy-based finance and commercial finance

In financing for the agricultural sector, a clear distinction needs to be drawn between the sphere of policy-based financing and that of commercial financing.

<u>1) Sphere of policy-based finance</u>

The primary sphere that policy-based finance should target is cases requiring a certain level of investment for the construction of public assets and semi-public assets from which the public benefits on a shared basis. Another important sphere is assistance to individual farmers who wish to modernize farming operations by making large investment that requires long-term return. The three policy-based financing areas relating to agricultural production are listed below.

i) Comprehensive development of agriculture, forestry, and fishing industries (ex. large-scale water projects for agricultural, forestry, and fishing industries and greening and environmental projects)
ii) Construction of small infrastructure for agriculture, forestry and fishery (ex. small-scale irrigation, elevators, and grain driers.)
iii) Agricultural modernization, technological remodeling, and soil improvement for farmland (ex. farm tractors and other agricultural machinery, greenhouses, and development of irrigation canals.)

<u>2) Sphere of commercial finance</u>

The following areas should fall within the scope of commercial lending by financial institutions of various types.

i) Lending by Agricultural Bank of China and other state-owned commercial banks

- Coordinated lending with policy-based financial institutions targeting comprehensive agricultural development and the construction of small-scale infrastructure for agriculture, forestry and fishery.
- Lending to private enterprises (so called "dragon-head" enterprises) and township and village enterprises engaged in agricultural production and rural enterprises, etc.

ii) Lending by Rural Cooperative Banks and Rural Credit Cooperatives

- Co-financing with policy-based financial institutions for the construction of small-scale infrastructure
- Loans for soil improvements of farmland for farmers
- Loans for planting and other agricultural operations for farmers
- Small loans to farmers

7.1.3 Realignment of rural finance to market principles and its diversification

(1) Issue concerning the reform of Rural Credit Cooperatives: Further reform of Rural Credit Cooperatives to bring them closer to regional realities

The past reforms concerning Rural Credit Cooperatives stressed organizational reform and reconstruction of business. No full-fledged efforts have been made to expand customer base, develop new products, or improve service quality. Improvements of operations will not only lead to sound management of Rural Credit Cooperatives but also to the delivery of quality financial services, which shall contribute to the prosperity of their customers including farmers and rural enterprises. Precisely for this reason, priority should be on measures to bring improvement to the operation of Rural Credit Cooperatives.

What is needed most for the reform of Rural Credit Cooperatives centering on operational improvements is indirect assistance, which enables them to demonstrate their own initiatives, rather than reform based on a top-down, uniform approach as was the case in past similar reforms. Specifically, it is important to provide assistance that supports their analyses of regional needs, information collection, and analyses geared to capture new customers and new financial products so that credit cooperatives' operational competency will be boosted.

(2) Diversification of rural finance

The diversification of rural financial markets needs to be encouraged, and in doing so, the state of the western region, i.e. its relative backwardness, has to be accounted for. Topics to be discussed should include microfinance, financial institutions in the form of cooperative associations, and transformation of informal financial institutions such as mutual aid associations to be transformed into formal businesses. In a region that lags behind in economic development, financial institutions in the style of cooperative associations are considered more appropriate than banking institutions since the needs of the members are better reflected in a democratic decision-making process in the former whereas banks places utmost importance on efficiency and profitability. Indeed, financial institutions in the style of cooperative associations could deliver high-quality financial services; provided that the size is kept at a modest level (for a village, or a town) to keep information and transaction costs low and that homogeneous membership (e.g., membership is restricted to farmers) is maintained.

7.2 Reform of agricultural policy-based financing

7.2.1 Mutually complementary relationship between public budget and policy-based financing

It is desirable that regional budget and policy-based finance can complement one another in the agricultural sector as well, so that policy-based financing can compensate for the lack of government money in achieving modernization of foundations for agricultural production. However, it seems that the combination of the two elements is not functioning properly at this point. This is largely attributable to the virtual non-existence of a mechanism of policy-based financing in the agricultural sector. Such a mechanism needs to be formulated, and a structure supporting its operation needs to be set in place as quickly as possible.

7.2.2 Policy-linked financing for agricultural development

The objective of policy-based financing is to assist projects of a public nature, which contribute to the modernization of agriculture, forestry and fishery, by extending loans. The Agricultural Development Bank of China, the current leader in this field, extends loans at present only to purchasing and stocking of crops, edible oils, and raw cotton. Additionally, the Agricultural Bank of China, which succeeded policy-based financing, has suspended many related operations. Therefore, the principal work of policy-based financing in the agricultural sector is not handled by any institution. For agricultural development, policy-based financing is desired. China shall have a choice of setting up a new policy-based financial institution similar to Japan's Agriculture, Forestry and Fisheries Finance Corporation or rebuilding the Agricultural Development Bank of China through restoration of its original objectives.

7.3 Stronger corporate culture for rural financial institutions

(1) Introduction of an auditor system to agricultural finance

Currently, the China Banking Regulatory Commission (CBRC) is responsible for the inspection of banks in China. For Rural Credit Banks and Rural Credit Cooperatives, which exceed 30,000 in number, a separate system of auditors for agricultural finance should be set up to strengthen and bring improvement to such institutions. Administering independent inspection, auditors of agricultural finance should be located in rural areas and carry out auditing of Rural Credit Banks and Rural Credit Cooperatives. This additional auditing system shall make the banks aware of any oversights or inadequacies in the areas of accounting, credit review and control, and in-house risk control structure and provide guidance for improvement.

(2) Establishing business ethics

It has not been unusual for Rural Credit Banks and Rural Credit Cooperatives to extend loans to regional projects and township and village enterprises under political pressure or instruction from the regional governments. Many cases of default have been reported on such loans. Rural Credit Banks and Rural Credit Cooperatives are finding difficulty in disposing the default created in this way.

Rural Credit Banks and Rural Credit Cooperatives need to assess prospective borrowers and their business details using their own gauges and based on their own lending criteria. It is crucial that loans should be granted based on the lending criteria.

Another concern of extreme importance for the institutions trusted with customers' money is the maintenance of depositors' confidence. It is essential that even small and medium financial institutions like Rural Credit Cooperatives, not to mention large banks, should be subject to auditing by certified public accounting and auditing organizations at all times to ensure fair accounting practice.

(3) Stronger structure for information collection and analysis

For lending-related decision making, it is extremely important to have accurate and up-to-the-minute information about companies, farms and/or projects that are of concern to pending loans on an ongoing basis. Equally crucial is information about matters beyond and above the borrowers or projects per se, including information that affects lending decisions indirectly, such as overall industrial trends.

When extending a loan to an individual farm, the farm's managerial principles pertaining to its agricultural operations, such as its agricultural operations, the types of products and livestock, and labor force mix, serve as decisive factors in assessing the farm's ability to repay and in evaluating the borrower's credibility. It is crucial to set up a structure that facilitates the collection of information on farmers for filing and analysis.

(4) Stronger disclosure

For the protection of depositors, financial statements of financial institutions must be disclosed periodically every year in accordance with a certain set of prescribed rules. It is important that disclosure rules are set forth and prescribe what items and timing to be released and the method of release. Financial institutions have to make disclosure accordingly.

(5) Coordination with projects aimed at agricultural development and extension

Projects for agricultural development and extension are ordinarily carried out with the leadership of relevant sections in the Ministry of Finance. Such projects are designed to disseminate agricultural technology most suited to each area, bring more advantages and convenience to agricultural management, and sharply increase farmers' income. Rural financial institutions should strengthen linkages with such projects aimed at agricultural development and extension.

8. Poverty alleviation and utilization of microfinance

8.1 Restructuring of public budget and poverty alleviation loans

A clear distinction of functions played by fiscal tools and lending tools has to be made for the effective execution of the two targeting at poverty alleviation.

8.1.1 Government fund

Fiscal tools should be allocated on a priority basis to non-a locatable public goods such as public infrastructure (ex. roads) and compulsory education and to areas with which the private sector alone cannot cope such as natural disasters.

(1) Road construction

Construction of roads is extremely effective in improving the economic environment of poor villages. Since the launch of the Western Development Strategy, new roads with enough width have been extended to the center of counties; however, access to points beyond is still less than desired, and the degree of road development is proportionate to the poverty level of villages. High priority has to be placed on road construction to link the poor villages.

(2) Compulsory education

Full-fledged funding on compulsory education by the national treasury should ensure equal opportunity to receive 9-year compulsory education throughout China, and expanded ranges of educational loans covering secondary school education needs to be considered. At the same time, bus routes should be expanded through road construction, and a plan to build secondary schools within commuting distance of students' homes should be formulated built immediately.

(3) Measures against natural disasters

Poor villages where natural conditions and infrastructure are not adequately equipped with are more prone to natural disasters such as droughts and floods. The government is encouraging migration from the areas of extremely harsh natural conditions while it takes steps to build infrastructure in areas with better natural conditions. However, damage by natural disasters remains high. The People's Insurance Company of China provides commercial agricultural insurance system in the coastal area, but no insurance mechanism is available in the poor areas except for disaster subsidies by regional governments. Policy efforts should be redoubled in areas such as infrastructure development, designed to minimize natural disasters; for example dams for drought-prone areas and dikes for flood-prone areas. Moreover, policy-based disaster relief funds for the agricultural sector should be created. Assistance for relocation including technical assistance should continuously be provided to people in areas underscored by excessively inferior natural conditions.

8.1.2 Poverty alleviation Loan

A growing proportion of the central treasury's poverty alleviation funds is fueled into the funding of poverty alleviation loans, whose default rate exceeds 40 percent as of the end of 2003 according to reports. Improvements in the following six areas are required to normalize the operation as a financial service.

(1) Operational accountability

It is appropriate to have the Agricultural Bank of China assume ultimate responsibility for collecting all debts as long as the Bank's financial assets are used to fund the loan program. However, with no branch network covering towns and villages, the Bank is not positioned to perform direct management over loans extended under poverty alleviation microfinance. Substitute management methods need to be examined to control its accounts. Additionally, a way to correct the inconsistency stemming from the Agricultural Bank of China, a commercial bank, still doubling as a window for policy-based lending should be explored.

(2) Scope of borrowers for lending

For effective utilization of limited public budget, it would be more appropriate if investment made for dividable assets, such as drainage and electric power, whose beneficiaries are clearly identifiable, were financed by financial instruments based on the 'beneficiaries pay' principle. In addition, lending to corporations or organizations that contribute to poverty alleviation activities should continue with respect to their projects.

(3) Credit limit

At the time of loan execution, the projected profit-and-loss and cash flow projections should be evaluated. When financing a project that benefits more than one household such as drainage and electric power, an operating entity would be set up to make sure that a mechanism ensuring the collection of income generated from investment is in place. At the same time, the party accountable for repayment would have to be clarified.

(4) Terms and conditions of repayment

Terms and conditions concerning repayment would be set forth in line with profit-and-loss and cash flow projections submitted for credit evaluation.

(5) Interest rate

Interest subsidies limited to one year might have the effect of generating additional borrowing demand. However, the necessity for such subsidies may not necessarily exist in light of the purposes for which the fund is used. Rather than providing interest subsidies on a uniform basis, the period and the rate of interest subsidies should be determined based on the concessionality of the loan purpose and projected income generated through the use of the loan. Extending interest subsidies to the loans of greater concessionality with terms exceeding one year should be considered. On the other hand, commercial rates should be applied to projects that are expected to generate sufficient profit in accordance with the principle of payment by beneficiaries.

(6) Coordination with regional governments

Efforts to coordinate between the loan officers and regional governments responsible for technological assistance should be sought. In other words, the roles of each player need to be clarified by having the Agricultural Bank of China perform financial services and regional governments extend technical assistance designed to boost effects derived from lending.

8.2 Microfinance

8.2.1 Problems surrounding microfinance

China has experimented with microfinance and expanded it since 1993. However, a number of people below the poverty line have not benefited from microfinance, even today. In order to extend the reach of microfinance, the following issues have to be addressed: 1) ways in which microfinance providers generate income sufficient to cover operational expenses 2) ways to lower the default rate, and 3) ways to improve impact from loans to the poor.

(1) Increased profitability for microfinance providers

The inability microfinance providers to expand the scope of their lending is attributable to the difficulties of securing profit due to the artificially depressed interest rates applicable to microfinance. In October 2004, the People's Bank of China relaxed the ceiling interest rate. Rural Credit Cooperatives are now allowed to set interest rates freely within 2.3 times of the prescribed base interest rate. However, prevailing opinion still argues that the interest rates for microfinance by Rural Credit Cooperatives should remain depressed because its customers are poor. In addition, microfinance by Agricultural Bank of China applies prime rate while 50 percent of the interest is subsidized by the government during the first year of lending.

The interest rates applied to microfinance executed by these financial institutions are not designed to cover funding and operational costs as well as the projected risk of default. They offset the shortfall in the microfinance by the profit earned from other financial products. And yet no tax break associated with the execution of microfinance is available.

(2) Risk control over default

In some other countries, microfinance is growing strong through efforts to secure a repayment rate of over 90 percent although its customers are poor. Yet, risk control over default is less than adequate in China.

The collection rate of microfinance extended by Rural Credit Cooperatives is said to be higher than that for other financial products[5]. However, no third-party evaluation can be made on this since no statistics of default rate classified by products have been released. Some warn of massive potential defaults. In any event, the repayment rate is not clear. On the other hand, the default rate of microfinance extended by Agricultural Bank of China is high. The lending and collection of microfinance by Agricultural Bank of China is handled by the officers of poverty alleviation department at county and town levels under

[5] See *Research Team for the Review on China Micro Credit Development* (2004) for details. The Rural Credit Cooperative Union of Gansu Province disclosed to the Study Team in January 2005 that its rate of defaulted loans did not exceed 10 percent.

commission by the Bank. Because this department is also responsible for the distribution of government subsidies for poverty alleviation, it is difficult to make borrowers aware of their repayment obligations. With respect to privately run microfinance operators, reliable data are not readily available since they lack mature and uniform accounting procedures.

8.2.2 Reform of microfinance

We proposed ten reform measures, which are designed to provide a comprehensive way to solve the above issues. Their actions vis-à-vis the above issues are summarized in Table 8-1.

Table 8-1 10 Areas for action and expected direct effects

Action Areas	Expected direct effects
Transformation of privately-run MF into systems Microfinance business run by private microfinance operators is to be authorized and approved as financial service.	Inflows of funds in the form of donations, etc. will be facilitated. An increase in the number of microfinance providers will enable a greater number of people with financial difficulties to obtain microfinance.
Review of interest rates Upon implementation of measures to achieve more efficient cost structure, interest rate setting that fully covers the costs is to be promoted.	Microfinance projects will generate profit.
Review of lending terms and conditions The term of the loan is to be aligned with the production period. Repayment before maturity is to be permitted based on the computation of daily pro rata interest. Loans to the poor are to be extended on the condition of installment.	The term of borrowing will match the funding needs detained in funding plans, and this will make it easier to inject funds into production activity. It also helps secure sources of funds to be allocated to repayment. This will lower actual interest rates. This will reduce the default risk.
Standardization and disclosure of accounting control Standardization and disclosure of accounting control are to be introduced as new obligations.	This will help formulate better business strategies and contribute to cost reductions of the microfinance institutions. Credibility as microfinance providers shall increase. Greater assistance shall be available including tax exemption from profit tax and receiving funds from the donors.
Promotion of information technology Management information system is to be introduced.	It will promote standardization of accounting. It will allow control over loans extended under diverse terms and conditions.

Action Areas	Expected direct effects
Review of center meeting function Center meeting is to be introduced to the group guarantee credit program to be in line with the reality of rural communities.	The center meeting will serve as a liaison where technical information provided by technology providers is accepted and re-channeled for sharing by participants. It will be utilized as a forum of discussion by participants, thus strengthening the underlying group guarantee system.
Increased coordination with technological providers The governments at county levels are to provide technological information needed by borrowers of microfinance for effective spending of the borrowed funds.	This will help achieve better results from the use of the borrowed funds.
Stable supplies of funds Fund inflows from donors are to be promoted. Terms and conditions for refinancing for pro-agricultural undertakings by People's Bank of China are to be reviewed.	It will help secure additional funds to benefit a greater number of the poor. It will allow lending whose term exceeds one year. The ability to raise funds under favorable conditions will lead to lowering interest rates.
Exemption from business tax Exemption from business tax for revenues from microfinance is to be given.	This will serve as a factor leading to the lowering of interest rates.
Institutionalization of the microfinance network The Microfinance Network, which is an organization supporting private microfinance operators, is to be institutionalized as an association.	It will help support the effort to strengthen the functions of private microfinance providers. It will help private-sector microfinance operators launch management information system. Higher recognition will be given to private microfinance providers, and this in turn will help increase donations to them.

Source: JICA Study Team

9. Development of industrial infrastructure and fund supply system

The development of industrial infrastructure is participated by 1) parties in charge of project execution, 2) central and local governments, and 3) domestic financial institutions, foreign governments, and transnational financial institutions. In the following, we elaborate issues that concern each group of participants and propose the direction which the reform of the capital supply system should take with the introduction of private-sector funds.

9.1 Operator in charge of project execution

9.1.1 Introduction of competition

When organizational reform based on the separation of the government and corporations is carried out through introducing private-sector functions to the public sector, a monopolistic corporation would appear with the characteristics of pubic inefficiency unless system of competition is introduced.

In order to avoid this, the principle of competition needs to be introduced through a break-up by region or by function. An alternative measure to secure competition is to open up the market and encourage competent private enterprises in China or outside with experience in business and cutting edge technology to enter the market as powerful competitors.

9.1.2 Utilization of comprehensive developmental capability of the private sector

Even with the presence of a competent private enterprise in or outside China with experience in running private business and cutting-edge technology, it would be difficult to ensure genuine grounds for fair competition if such a company was be forced to compete with a gigantic monopolistic enterprise like a national railway company without breaking up the latter. In fact, many countries have paved the way for fair competition by first breaking up the monopolistic corporation. An alternative to be considered would be to take advantage of the comprehensive planning and development abilities of private enterprises with great business acumen and financial strength if such companies exist.

It is extremely difficult for a private-sector enterprise to enter the Green Field Project (Development project for a new rail service) of the railroad sector using the BOT technique and to transform itself into a competitor of the national railway company in the process of competition and collaboration with the latter. This is attributable to the difficulty of generating enough traffic demand for a transportation project on a stand-alone basis since it is crucial to raise transportation demand in collaboration with other modes of transportation in the surrounding areas. Furthermore, it is necessary to raise income from synergies between the flows of people and commodities created from the transportation and related businesses such as distribution and events. In other words, new participants shall join in the sector if comprehensive development including transportation, tourism, business, commerce, and public services along the route is to be undertaken.

9.2 Central government

9.2.1 Rational allocation of investment projects within the government and between the government and the public sector

(1) Use of commercial funds obtained for self-funding projects

In view of the above issues surrounding fund injection, budget-based funds are shrinking. The use of funds obtained from the market should be maximized for commercial projects (e.g. fully commercial projects such as oil and natural-gas development, electric power, toll roads, telecommunications, most projects relating to water and gas supply for municipalities and sewage disposal; semi-commercial projects such as comprehensive water-related facilities, postal administration, airports, most water and gas supply for municipalities and sewage disposal).

(2) Priority injection of governmental fund to projects designed for public welfare

The government should give priority to funding for non-commercial projects, which have little self-supporting ability such as protection of the ecosystem and environment, urban roads, education, culture, health and hygiene, and other social work projects.

9.2.2 Creation of a structure and mechanism that facilitate diversification of investors and sources of funds

(1) Absorption of additional funds from domestic and foreign sources through achieving further improvements in the investment environment

The current conditions do not satisfy requirements for allowing private capital, both Chinese and foreign, to participate in China's infrastructure segment. At the moment, reform of managerial structures is underway in some parts of the public sector. However, introductions of deregulation and competitions, which allow participation by Chinese and overseas private-sector companies in infrastructure segment, have not been realized. In the Notice Concerning the Western Development Plans, it is indicated that railways, roads, other transportation projects, and public service projects will be opened up to foreign capital in the western region on an experimental basis. By taking this statement a step further, more proactive efforts to create and design an investment environment that facilitates the private-sector participation should be made through implementing actions concerning profitability and risk hedges, commitments by the government, and long-term assurance for profitability.

(2) Use of domestic private-sector fund for infrastructure-related projects

China's domestic companies, judged from the current state of their evolution, are not yet equipped to compete for transportation projects with privatized organizations created out of managerial structural reform. However, it is crucial to create an environment that allows participation by domestic private enterprises experiencing business growth in the eastern coastal region if the social and economic gaps between regions are indeed expected to narrow through contribution from the eastern region. In fact, some buildup of private-sector capital is seen even in provincial locations, not to mention the eastern coastal region. In fact, regional enterprises, including those with equity participation by provincial governments, account for 21.3 percent of the investment in regional freeway investment funds.

Methods of PPP (public private partnership)
In the process of privatizing public organizations, deregulation and the introduction of competition on one hand and reform on managerial structure on the other serve as two pillars.

(1) Processes of deregulation and phasing in of competition
- Service agreement (specification-based contracting and performance-based contracting)
- Management agreement
- "Afterimage" agreement
- Concession agreement
- BOT method

(2) Reform of managerial organization (Introduction of private-sector functions)
- Commercialization
- Corporatization
- Introduction of external knowledges (Strategic partners with superior technology and/or managerial competency)
- Partial sale (Private Offer, Public Offer)
- Complete sale (Private Offer, Public Offer)

Source: JICA Study Team

(3) Acceleration of open markets for more foreign investment

Efforts to open up markets should be extended beyond the "fields where significant investment and fast-evolving technology are indispensable, i.e. the petroleum and natural gas sector and communications," to such areas where comprehensive developmental abilities of foreign capital companies could serve as a driver. Opening up allows exposure to competition and builds the market competitiveness.

9.3 Regional governments

9.3.1 Fostering policy formulation ability

A greater role is expected to be played by regional governments in the Western Development Project except for the national projects that were put into action from 2000 through 2003. In particular, policies for improving investment environment pertaining to implementation of the Project fall under the responsibilities of the regional governments. It is extremely important for them to develop policy-formulating abilities and to effectively utilize the power delegated to them in the areas of preferential taxes, resource pricing, tariff pricing, and product pricing.

9.3.2 Familiarization with market economy and opening up to the external world

Unlike the central government and regional governments in the eastern coastal region, regional governments of the western region have had little exposure to the market economy and the opening of markets to foreign businesses. For this reason, many of the regional governments in the western region follow instructions of the central government when administering policies, displaying a lack of initiative in their undertakings. In order for the regional governments to properly carry out western regional development, it is essential for them to be familiarized with the market economy and opening up of markets, to proactively absorb the knowledge needed for the execution of policies, and to learn about application techniques.

9.3.3 Proper exercise of delegated authority

Regional governments have to carry out policies that have no precedent even by the central government such as "the creation of a special fare tariff for a new railway in the western region" and "the opening of road transport and public service sectors to foreign capital on an experimental basis in the western region". For successful execution of such policy measures, the regional governments are required to cultivate proper decision-making ability on their own in addition to close cooperation with the central government.

9.4 Domestic financial institutions

9.4.1 Development of banks capable of acting as lead manager in project finance

With respect to projects participated in by domestic and foreign private companies, the participants, especially multinational companies, acting as project operators are likely to demand advanced financial transactions that are well practiced in the developed countries. The first challenge would be project finance (PF). Banks may have experiences of participating in general PF, but when making financial transactions on project finance, they would be required to arrange transactions that fully comply with international standards and to lead the transactions. It is essential to foster specialists in project finance, to set up an organization, and to gain experience in this area.

9.4.2 Development of legal structure allowing participation in advanced loans method

Complex contracts are involved in the advanced loan method. A legal system and judicial system in support of this must be established in order to make the contracts pertaining to PF governed by Chinese laws be effective for the contract parties as well as the third parties.

The legal structure clarifying complex rights and obligations, guarantee, project asset collateral, processing of senior and subordinate conditions and bankruptcy, among others, needs to be established urgently.

9.4.3 Enhanced system for credit risk control

Sophisticated credit risk control has to be in place if loans that do not follow standard credit guidelines, are to be extended; i.e. loans not based on the strict credit guidelines. A credit risk control system along with operation department staffed with highly trained specialists has to be established.

9.4.4 Opening of branches by foreign banks in the western region and authorization for RMB-based transactions

Multinational enterprises require teaming up with multinational banks, which have partnered for other projects overseas, in order to participate in industrial infrastructure-related projects noted with high risk profiles. In other words, risk sharing and financial assistance by multinational banks are inseparable from such projects.

The proportion of RMB-based transactions is higher for industrial infrastructure-related development than for projects handled by export-oriented enterprises in the eastern coastal region. In addition, in many cases, such infrastructure-related projects may take over 20 years to complete, thus the terms of financial transactions for them may be long. In light of these factors, it is important to allow the bank, with which a multinational participant has had strong relationships in its base country, to establish a branch in the western region and deliver assistance including RMB-based transactions over a long period of time. Thus, the opening of a branch by the partner bank of a multinational company along with permission to the bank for RMB transactions would be highly desired.
This will also present opportunities for domestic financial institutions to learn advanced financial techniques of foreign banks.

9.5 Foreign governments and international financial institutions

Japan, the largest provider of aid to China, has kept a strong eye on the economic and social development of China's interior in its execution of economic cooperation projects. Recent examples of specific assistance in the western region include yen-denominated loans for non-profit projects relating to environmental development, human resource development, afforestation with trees and grass, and local roads.

It is expected that the Chinese government will deepen policy dialogues with concerned countries and international organizations in order to utilize developmental assistance for non-profit projects in the western region in line with assistance principles of donor agencies.

III. Reforms of financial systems

III Reforms of Financial Systems

10. Reform of policy-based financial system

For effective results to be achieved from the Western Development Strategy, a review of the policy-based financial system is needed to undertake a reform that precisely meets policy requirements.

10.1 Roles of policy-based finance

10.1.1 Necessity of policy-based finance

(1) Bottlenecks in fund supply

Bottlenecks along the fund supply channel are found in the financial market, owing to "market failures" and other factors. They result in the failure to fuel funds into the fields to which such funds should be rightfully supplied. The bottlenecks are largely found in the cases described below:

① Cases where loans are not extended due to statutory rules, customs, or asymmetry of information although the income projection based on the discounted cash flows exceeds the present value of costs; such as lending to small and medium enterprises, ventures, and the software industry.

② Cases where loans are not extended due to insufficiency in economic returns although social benefits to be derived from the project are expected to be high; such as financing for environmental projects including desulfurization/dust collection plants and sewage treatment plants.

③ Cases where loans are not extended due to high credit risks and difficulties in preventing such risks; such as cases where genuinely high-risk profiles are confirmed by proper risk evaluations or the term of the loan is too long to make risk assessment.

(2) Difficulties in assessing public benefit and risks

Cases containing bottlenecks as presented above do not always fall within the scope of policy-based finance. Expanding the scope of work to be handled by commercial financial institutions is of utmost importance through financial system reform and changes in custom and practice that ensure the full functioning of the market mechanism. The raison d'etre of policy-based finance is clearly evident in cases where the "necessity of policy" is apparent and the cases "need to be addressed by means of financial functions". Specifically, the cases that fall under the following two conditions are where policy-based finance is clearly needed.[6]

1) Public welfare
Financial intervention by the government is expected to increase benefits of the national economy in cases where social benefits exceed social costs, and "greater public welfare" can be created through policy assistance.

2) Difficulties in making assessments of financial risk
Policy-linked financing may take the place of commercial lending if commercial lending cannot assess the risk involved in lending in such cases as inadequacy of information, an extremely high degree of uncertainty stemming from long lending terms, or extremely high risks.

Based on above standards and in view of the realities of Chinese economy, the bottlenecked supply channels that the policy-based finance is to be extended need to be clarified.

[6] Based on "About Policy linked Financial Reform" by Council on Economic and Fiscal Policy (December 13, 2002)

10.1.2 Functions of policy-based finance

(1) Complementing and guiding the commercial financing

One important matter to be noted in conjunction with the reorganization of the policy-based financial system is that policy-based finance is something that serves as a complement to commercial lending and that the execution of policy-based financing is expected to guide the commercial lending. For instance, co-financing that combine policy-based and commercial financing is a straightforward example of the guiding function.

(2) Correcting unevenly distribution

In many cases, lending to small and medium enterprises and farmers is accompanied by high risk combined with low profitability. Therefore, this is one area in which commercial lending does not fully render its service. Similarly, capital flows may be constrained with respect to projects aimed at infrastructure development in an underdeveloped area. Such projects may earn high marks in social benefits, but generally low in projected profitability. Restructuring the policy-based finance for the fields and areas stated above is expected to correct the uneven capital distribution to certain fields and regions.

10.1.3 Measures to assist policy-based financing

In policy-based financing, low interest rates or long terms may be offered if policy so requests. Adequate funds that enable preferential conditions have to be in place for the public financing in terms of provision of low, long-term, or fixed interest rate. There are two approaches to the funding of policy-based finance: one is the utilization of no-cost funds from the government in addition to funding from the market, and the other is through the receipt of subsidies for any negative interest rate spread. It should be noted that both approaches must be accompanied by necessary fiscal measures.

10.2 Issues relating to policy-based financing by field

In light of the functions that should be played by policy-based finance described above, issues surrounding Chinese policy-based financing are listed in the following for each field.

10.2.1 Development of infrastructure and industrial assistance

(1) Large-scale projects

At present, China Development Bank serves as a policy-based financial institution for national-level projects and other large-scale projects. However, its utmost stress on the certainty of repayment and profitability effectively limits the scope of projects the Bank can cover as a policy-based financial institution. The certainty of repayment is a crucial condition of lending by any financial institution. However, the Bank should consider extending financing to projects with a relatively high-risk profile provided that the project is expected to contribute significantly to the public interest, that it is required from long-term perspectives, and that its risks can somehow be overcome.

For projects of social importance which require long-term funding despite low expected returns, e.g. environmental projects, another policy means might be combined to set up funds of greater concessionality than general cases in terms of the interest rate and period of repayment. This is one lending sphere to which China Development Bank should increase its exposure.

(2) Small and medium projects

China Development Bank extends policy-based lending to infrastructure-related projects of the national level as well as major infrastructure-related projects of the provincial level. However, no financial institution is dedicated to extend policy-based loans to infrastructure-related projects below the provincial level. In future, the construction of infrastructure would have to be made on a more focused and selective basis.

China will have to give up the mega-project dogma. For fairer distribution of public service, building projects for small and medium-scale infrastructure should be launched in urban centers and rural villages where community foundations need to be formed. The system of policy-based financing needs to be clarified in order to promote this trend.

(3) Regional consideration

In connection with lending by China Development Bank, it should be added that the Bank's outstanding loans to the western region are declining due to its strong bias towards profitable projects. In terms of the loan period of the projects with the low projected profitability, the western region receives up to 30 year repayment period as opposed to maximum lending term of 25 years in other regions. On the other hand, the applicable interest rates are uniform for all projects across the nation at the rates of 90 percent of standard lending rates, and no special consideration has been given to the western region.

A systematic framework designed specifically for the promotion of western regional development should be set up in order to provide loans of greater concessional conditions for the projects with tremendous public benefit in spite of their low profit projection.

(4) Industrial promotion

As the market economy matures in tandem with economic growth, the degree of interference by the government in the decision making of the private sector must be reduced. The allocation of funds should also be left to a greater degree to the market mechanism. From these perspectives, funds to large enterprises should be channeled increasingly through commercial lending, which should gradually replace policy-based finance.

Meanwhile, sufficient profit is not likely in the short run for investment in plants and equipment by enterprises for the purposes of implementing measures against gas emissions, noises, and discharged water as well as measures for energy conservation and product recycling. Policy measures that encourage investment relating to these undertakings should be available provided that profitability over a long run is likely or that significant social benefit is to be reaped from such investment. In such case, investment assistance through long-term, low rate lending would be required.

The sphere of industrial finance, requiring policy consideration as described above, is one area in which China Development Bank and other financial institutions should increase their loans.

10.2.2 Development of agriculture, forestry and fishery

As stated in 7.1.2 above, policy-based financing in agriculture, forestry and fishery should be used to fund 1) comprehensive development of agriculture, forestry and fishery; 2) small infrastructure construction for agriculture, forestry and fishery; and 3) agricultural modernization and technical modification for farmers and lending for soil improvement.

Of the above, the Agricultural Development Bank of China conducted policy-based finance for 1) and 2) between 1994 and 1998. Policy-linked financing to the two areas has been suspended since then. Thus policy-based financing to address basic agricultural needs has been absent. For 3) above, policy-based financing was considered unnecessary in the past, but the extension of policy finance to cover agricultural investments by farmers is an important issue since it directly relates the solution of "three rural issues".

10.2.3 Promotion of imports and exports

Advanced nations share common understanding that public assistance is needed for trade promotion because of competition existing among the national governments and political risks attached to exports and investment to developing nations. Generally, policy-based finance relating to the promotion of imports and exports include 1) export loans for large machinery, vessels, and electronics products, etc., 2) importation of large machinery, aircraft, and vessels, and 3) development and importation of resources.

Currently, the Export-Import Bank of China primarily performs financial services relating to 1) above, and its size of credit facility is ranked third in the world after Japan Bank for International Cooperation and the Export-Import Bank of the United States. However, the loan execution for 2) and 3) is extremely limited although it is technically possible to extend them now. Loans for investment overseas for resource development are expected to grow since China will incline to develop resources overseas and import at its own risk by utilizing the sharply increased reserves of foreign currency.

10.2.4 Promotion of small and medium enterprises

The role played by small and medium enterprises in absorbing supply of the laborers is substantial for the economic activity. There is a world consensus that small and medium enterprises should be supported by policy-based financing because financial markets for small and medium enterprises often fail to function satisfactorily even in advanced countries.

(1) Loans

Small and medium enterprises lack credit strength as individual because of their size and their high credit risks. Moreover, the collateral secured in conjunction with loans to small and medium enterprises may not be sufficient in terms of quantity or quality, and this will serve as an additional problem. In China, corporate lending to small and medium enterprises is de facto relegated to commercial banks including state-owned commercial banks, joint stock commercial banks, and city banks. Access to funds by small and medium enterprises constitutes a significant area of challenge. There are cases where China Development Bank teams up with the government of Chongqing City for corporate loans to small and medium enterprises on an experimental basis. Lending to small and medium enterprises is considered a special field, and it would be appropriate to set up a policy-based financial institution specialized in financing for small and medium enterprises.

(2) Guarantee

In China there are a number of small and medium credit guarantee agencies affiliated with city governments and those in the private sector. However, the credit strength of each agency is rather limited, and the ability to guarantee debts is likewise limited. The ability to guarantee credit must be strengthened through consolidating agencies affiliated with local governments into a group and private agencies into another group, thus enlarging corporate size.

(3) Technological assistance and personnel development

Compared to larger corporations, small and medium enterprises are weak in every aspect of business operations including human resources, production technology, and managerial know-how. Assistance in the form of consultation for managerial issues, access to markets, better production technology, and more sophisticated practice in accounting and financial matters would be desired. It is also hoped that the policy-based financial institution dedicated to small and medium enterprises will provide seminars and consultations on above mentioned issues.

10.2.5 Regional development

In order to close the gap and to promote harmonious growth across regions, the redistribution mechanism by the governmental funding needs to be strengthened while policy-based financial system for the regional development is to be improved.

Regional development at the regional government level rests on the level of funds available at the regional government, which has only limited funds. Looking ahead, budget allocations from central finance would not come out easily even if the decision to increase trans-regional transfer of government funds is to be made. The tight financial state of the western region in particular is assumed to continue. Therefore, a special scheme of policy finance for the western development needs to be set up to accelerate the western regional development.

11. Enhancement of regional financial systems

The following measures are proposed to achieve expanded regional finance:

11.1 Maintaining coordination between regional development finance and national monetary policy

The stability and sustainable growth of the macro economy of the entire nation is an indispensable condition for regional economic growth. Regional development finance for the west has to be consistent with the monetary policy of the central government aiming at the stability and sustainable growth of the macro economy. The central government, after ensuring the operational stability of the nationwide macro economy, needs to adjust the level of funds supplied to regions in such a way as to achieve balanced growth across the regions. The branch offices of the People's Bank of China are responsible for monitoring regional monetary trends and the execution of monetary policies in their respective regions. They are required to formulate a medium and long-term outlook for the supply and demand of funds and to utilize it for the formulation of monetary policy and for the development of local financial institutions.

11.2 Designing systems for development according to regional characteristics

In the western development, quality of funds to be injected needs to be improved much more than quantity. For this, a growth strategy by region, by field, and by developmental issue needs to be formulated. In each strategy, a phases-by-phase scenario for development should be drawn, and a regional development financial system should be designed. According to this scenario, necessary funds should be injected. In implementation, it is essential to clearly differentiate between the fields where private financing takes the primary role based on the market mechanism and those where the government funds or policy-based lending are required for promoting public benefits.

11.3 Boosting the function of plan coordination by the regional government

The regional government is responsible for the social and economic development of the respective region. The government may increasingly resort to PPP (Public-Private Partnership) and other modes of collaboration for the regional development in order to diversify funding channels and to utilize private-sector initiatives. The regional government, which acts as coordinator and promoter of regional development, will be required to boost its ability to coordinate project planning.

11.3.1 Establishing governance

Lack of transparency by the regional government has been pointed out as a problem. There are reports that even the national government is in no position to accurately understand the degree of the indebtedness of regional governments if debt guarantees written by regional governments are included. Efforts are required in reforming public administration and finance in order to strengthen the administrative control and auditing structure of the regional government and to enhance its governance. Without sufficient management abilities and governance of the regional government, a significant injection of funds will result in inefficiency. Another agenda is the creation of an independent specialized committee or organ outside of the government to handle preliminary assessment, monitoring, and a posteriori assessment of developmental projects implemented by the regional government.

11.3.2 Developing abilities to plan and execute a project

Capital investment by the government plays an important role in formation of fixed assets in the region. However, the regional government has reportedly made investment decisions based on following in the footsteps of other regional governments or on easy business outlook in many cases. It is a precondition for the effective use of development funds that the abilities of the regional government to formulate plans and to execute projects are developed and that institutions are built for efficient execution of projects, which are truly needed for the regional development.

11.3.3 Promoting deregulation

To solve structural fiscal difficulties, the administrative organization should be downsized, and some governmental services should be relegated to the private sector to the extent that the private sector is capable. A number of restrictions by the regional governments on corporate activities of private enterprises still remain. Creating a business environment where corporations including private enterprises can conduct activities with freedom will result in vitalization of the regional economy.

11.4 Stabilizing finance of the regional governments

After launching the separate collection of tax revenues for central and regional finance, tax revenues allocated to the regional governments decreased. Transfer payment from central finance to the local finance allows funds to be redirected to backward areas including the western region. The payment is mostly directed to selected fields such as infrastructure development, agricultural development, social security, policy-based subsidies, public business organizations, and administrative control. On the other hand, the regional government is forced to make do with limited tax revenues to administer measures relating to education, health and hygiene, and the maintenance of urban construction. All levels of government below the provincial, particularly the lower ends of government such as town and village-level governments, are reportedly severely strapped.

11.4.1 Reexamining sources of revenue for regional governments

There is room to examine the possibility of increasing revenue source for the regional finance based on clarification of the roles and functions between the central and regional governments in China. Sources of revenue for regional governments, their tax rates, and taxation bases need to be rationalized in order to secure necessary funds for the regional governments to perform their administrative functions.

11.4.2 Possibility of issuing municipal bonds

There are several issues surrounding the issuance of bonds by regional governments including ways to secure cash for repayment, ways for regional governments to secure operational autonomy, and ways to monitor the issuance by the central government. Also, there is a concern over the possibility of an excessive or unplanned issuance by the regional governments. An appropriate system has to be set in place prior to issuance encompassing approval, authorization, and supervision by the central government, financial disclosure by regional governments, a credit rating system, the development of secondary markets for municipal governments, and preventive measures against illicit deals, etc.

11.5 Enhancing region-based banks

Creation of a regional financial mechanism rooted strongly in the community is important for revitalization of the financial system in the western region. Complementing state-owned commercial banks, more local-based financial institutions are needed. The expansion and enhancement of regional financial institutions may be achieved through 1) encouraging the formation of commercial banks in provincial areas; 2) creation of banks covering wider areas; or 3) utilization of the postal savings bank.

11.6 Enhancing community-based lending

Regional financial institutions can build close business relationships with customers through the delivery of community-based banking services. Ideally, they should build a structure suited for loan execution (relationship banking), where business information on customers is accumulated, borrowers are rated according to the information acquired, and an interest rate that corresponds to the level of projected risks associated with lending is decided.

Ways to enable lending services with more meticulous care through the use of local NGOs should also be explored. One approach is to set up a mechanism where a financial service organization in the form of a non-profit organization (NPO) is to be formed and financial institutions are to extend loans to the NPO.

Another approach is to require banks to extend loans equivalent to a certain prescribed percentage to designated targets within the community. For instance, banks might be requested to raise their loans to small and medium enterprises or for projects geared to community development to reach the level equivalent to a certain percentage of their outstanding deposits. Incentives such as preferential taxes might be accorded to banks that have satisfied prescribed requirements.

11.7 Diversifying fund suppliers

11.7.1 Vitalizing investment trusts that invest in the western region

Investment trusts targeting at the western region are recommended to be promoted. Specialized financial institutions like investment trust companies pool investors' money, which serves as a base fund to fuel more money to the western region. To achieve this, attractive investment targets have to exist in the western region. Projects of greater appeal need to be created such as project bonds to be issued in connection with the western region development, PFI and BOT projects, and projects based on securitization of receivables.

11.7.2 Utilization of charitable trusts

Chapter 6 of the Trust Law stipulates that charitable trusts may be set up for the public welfare projects such as poverty alleviation, education, culture, environmental protection, and eco-system maintenance. Collaboration between the government and the private sector in the areas of poverty, social welfare, education, and environment will be brought to a higher level through the use of charitable trusts whose funds jointly injected by the private sector. Currently, the Ministry of Civil Affairs and the China Banking Regulatory Commission are examining the prospect of institutionalizing the charitable trust system. Special perks for corporate and individual donators such as tax breaks should be considered, and increased awareness and penetration of charitable funds should be achieved by educating the public.

The trust system should eventually evolve to cover community-based development trusts, which need to be nurtured in future.

11.8 Creation of special funds that meet the needs of regional development

Special funds should be set up to provide necessary capital for areas to which private-sector funds are not likely to be directed due to their lack of commercial appeal such as education, medicine, environmental preservation, and rural community development. The special funds referred to in this section are those financed by the government and designated to provide developmental financial services for specific purposes.

11.9 Examining an idea of creating the western development bank

With respect to an idea to establish a western development bank, a new policy-based bank in the west for the purpose of extending finance to that region, the relevance and effectiveness of the bank should be investigated. Factors to be considered should include the following: 1) how to deal with the vast size of the western region with varied subregions; 2) how to draw a line of demarcation between the western region and similar areas outside the western region; and 3) how to draw lines of demarcation among the three existing policy-based banks.

If the creation of the western development bank is decided, several options need to be considered; i.e. 1) whether investment and lending in the west region handled by the existing policy-based banks would be transferred to the new bank; 2) whether the new bank should extend low-rate, long-term loans to the target lending spheres which are also served by the existing policy-based banks provided that projects satisfy certain conditions; and 3) whether investment and lending by the new bank will be directed to areas not addressed by the existing policy-based banks.

Based on the comprehensive examination of the requirements that policy-based financial institutions should satisfy the promotion of western development, utilizing the managerial resources of China Development Bank and Agricultural Development Bank of China are considered to bring in more benefits while the former primarily deal with infrastructure construction, and the latter primarily serves for agricultural finance. To satisfy the needs of infrastructure development in the western region, the Western Development Fund, functioning as an independent organization, should be set up upon securing close collaboration with China Development Bank.

11.10 Introducing a special tax earmarked for environmental protection and eco-system maintenance

The cost of environmental preservation for the western region should also be borne by other regions as beneficiaries. Environmental protection tax should be introduced to establish a mechanism of sharing expenses for environmental protection and the maintenance of the eco-system. The environmental protection tax will be earmarked to finance environmental protection and eco-system maintenance in the western region. Another option is to set up a fund for the environmental protection of the western region with the environmental protection tax as the main source. The tax may also be used to provide subsidies to the private sector, which invests into environmental projects.

12. Reorganizing capital markets

12.1 Developing bond market

The development of the bond market is expected to benefit fund seekers in the western region since bond issues contribute to an increase in funding channels. In addition, more appropriate dispersion of financial risks among investors through the market mechanism would be achieved with participation by a broader range of investors. However, issues involved in development of the bond market need to be tackled such as increased diversification of bond issuers, acceleration of procedures relating to issuance, a more organized secondary market, and securing of fair transactions based on full enforcement of disclosure requirements.

12.1.1 Diversification and expansion of bond issues

(1) Limited-recourse bond issues

Non-recourse and limited-recourse bonds should be issued. Repayment and interest payments of such bonds are made from specific cash-flows generated from a certain business. The capitalists of the business such as parent companies have no liability for the payment of non-recourse bonds and limited liabilities to the limited-recourse bonds. For the successful floating of these bonds, a rating system for infrastructure-related projects needs to be in place, and the primary and secondary markets must be developed. In addition, institutional investors with the ability to manage investment risks have to be reared.

(2) Increasing the number of qualified bond issuers

As it stands now, bond issuance is limited to large corporations. It is hoped that bonds will be issued by a broader range of corporations including small and medium state-owned enterprises and privately-run companies on varied conditions in accordance with the credit risks determined by a fair rating system and information disclosure with strict conformance.

(3) More varied terms and conditions for security and guarantee

At present, corporate bond issues are accompanied by bank guarantees. However, one characteristic of corporate bonds relates to the role of market investors, who bear financial risks in lieu of banks. To save this feature of corporate bonds, corporate bonds should be able to be issued with more varieties including their ratings and conditions on collateral and security.

(4) Flexible interest rates

No mechanism is in place to allow the market to freely decide interest rates of bonds based on the creditability of issuers. Adding more flexibility to interest rates of corporate bonds should be discussed in a long-term and shall be realized as interest-rate liberalization progresses.

(5) Increase in short-term bonds

The greater use of short-term bonds issued by corporations engaged in western development projects or by those seeking short-term funding for businesses in the western region would be effective in reducing their reliance on bank lending.

To promote the use of short-term bonds, costs of issues need to be reduced, and a better trading environment needs to be established. Future set up of a depositary and book-entry transfer organization, which allows book-entry transfer without paper issuance, has to be considered. Additionally, medium-term notes (MTNs) can add flexibility to corporate bonds since MTNs allow a company to issue bonds at the time of necessity up to the prescribed amount with varied conditions based on the basic agreement concluded between the issuance company and a security firm in advance.

12.1.2 Increased funding through securitization

Various schemes based on asset securitization can be used to finance a variety of projects for the western regional development. Some examples of such schemes are financing for urban development and infrastructure construction and liquidation of loans provided for enterprises in the western region. Securitization of the loan portfolio held by financial institutions vis-à-vis the western region could improve the balance structure and risk dispersion of financial institutions.

At present, China Development Bank, commercial banks, and asset-management companies are undergoing preparation for asset securitization. Asset securitization not only brings asset restructuring and risk dispersion to banks but also makes available a more diverse range of financial products on capital markets. To securitize assets, the legal structure that supports securitization must be in place including the legal status of special purpose vehicles (SPVs), risk control, and guarantee of investors' rights. Review of the existing statutes such as the Company Law and the Corporate Bankruptcy Law are also necessary for creating an asset securitization mechanism.

12.1.3 Issuance of municipal bonds

The possibility of issuance of municipal bonds, as discussed in 11.4.2, needs to be examined for increasing the fund of the regional governments.

12.1.4 Fostering institutional investors

Fostering institutional investors helps vitalize the bond market, which brings more funds to the western regional development. A mechanism needs to be set up to effectively link the demand for the high-risk fund in the western region and a broader range of investors among whom the risks are shared in the bond market.

To attract investment by institutional investors, the first step to be taken is to expand the range of bonds to satisfy investors' diverse risk preferences and investment styles. At the same time, institutional investors need a high level of investment skills. In addition, the presence of a fair rating organization in charge of evaluating credit risks associated with corporate bonds is necessary to ensure investors' access to adequate information for evaluating risks.

12.1.5 Development of basic system for the bond markets

Organizing fundamental systems for the bond market is important to fuel more funds to western regional development as discussed above. It would be necessary to establish transaction rules and customs based on international standards and to build a market which serves as an intermediary of funds with arbitrage function based on market principles. Also, the reliability of the rating agency and the disclosure system need to be further improved.

12.2 Reorganizing stock market

The stock market in China has been sluggish since the latter half of 2001. The weakness is mainly attributable to the problems of non-circulating stocks, corporate governance, and a lack of confidence in the accuracy and transparency of disclosed information.

12.2.1 Ensuring credibility of listed enterprises

Many state-owned enterprises went public after separating their principal business lines and assets and making them independent. However, investors do not have full trust in these listed state-owned enterprises. This is because management of the parent company, which exists behind the listed state-owned enterprise, is elusive, and corporate governance independent of the parent is incomplete. It is of utmost importance to set solid corporate governance of state-owned enterprises to restore investors' confidence.

In addition, increased transparency in accounting and finance is required to ensure that the disclosed financial statement accurately reflects the state of business, that the company does not have hidden or off-balance-sheet liabilities and guarantees (ex. those relating to social security as conventionally borne by state-owned enterprises), and that the company does not have significant contingent risks from derivative transactions.

12.2.2 Stability and fostering of the stock market

The release of large amounts of non-circulating shares to the market is a requisite to accelerate the privatization of state-owned enterprises. It is crucial to administer orderly releases of such shares while making sure the stock market comes out of the downturn. The restoration of general investor confidence is crucial for the stable development of the stock market. To this end, variety of measures for improvements should be administered including the evaluation and supervisory system for listed companies and information accumulation by securities firms and institutional investors.

12.3 Diversifying direct financing

Direct financing only accounts for about 18 percent of all financing in China, and financial institutions constitute the majority of the investors in the direct financing. To expand the stock and bond markets, it is crucial to channel the general public's saving and bank deposits to stock and bond investment.

This requires measures to boost investors' confidence in listed corporations, to promote the vitalization of the stock market, and to improve accessibility to the bond market. For better accessibility to the bond market, the range of investment funds have to be expanded into those including stock investments funds, bond investment funds, and combination funds of stocks and bonds. Further expansion of capital markets needs to be carried out through development of relevant laws and security investment products.

12.4 Creating a stock exchange market in the western region

The strong reliance on indirect financing across the nation is even more pronounced in the western region. In order to facilitate full-fledged western development, it is essential that its economic growth be supported not only by indirect financing but also by direct financing.

Creating a stock exchange market in the western region has significant relevance if considered that China has vast land, that the evolution of the stock market in China is still at an early stage, that the stock exchange has a function of discovering and fostering enterprises, and that urban centers of relatively large size already exist in the western region.

13. Developing Structure of the Financial Risk Control

13.1 Issues relating to financial risk control by the financial regulatory authorities

Financial institutions need to administer risk control which is properly aligned with changes in their business scope and risk profiles. The financial risks not only have been increased but also became diversified and complex. For the prevention of confusion and disruption of the financial system, the financial supervisory authorities should step up its supervision over financial institutions and set in place appropriate foundations that allow financial institutions to control financial risks.

13.1.1 Risk control that addresses a shift to financial transactions

In China, financial transactions are not yet fully institutionalized. Even today, there are loans that are concluded as though they are disbursements of cash and lending based on personal considerations and favoritism. They cause delay, refusal, or evasion of repayment by borrowers. These cases are the major factor for bad loans that plague financial institutions.

The bad loans created in above situations are not attributable to ordinary credit risks and thus will not be easily reduced by strict credit assessments and credit risk control administered by financial institutions.

First and foremost, it is necessary to clearly put in order and differentiate fiscal disbursement and lending to minimize this type of risk. And this action is predicated on the financial system, which has to be capable of fully protecting the rights and obligations of the parties involved in financial transactions and agreement. For the protection of creditors' rights in financial transactions, laws designed to ensure fair transactions including those relating to economic transactions and bankruptcy must be in place in addition to the civil and commercial laws. In addition to establishing these laws, the judicial system, including the trial system, has to be set up for enforcement.

13.1.2 Risk control that addresses financial liberalization

Progress in financial system reform and financial liberalization calls for new system for risk controls including risks associated with interest rates, foreign exchange, and price fluctuations in addition to the conventional credit risk. Progress in financial liberalization reduces the task of regulations designed for controlling risks. Financial institutions need to build self-controlling system of the risk management accompanied with the corporate governance. They also need to change their risk control methods to asset liability management (ALM) and other techniques that comply with ratio-based management rules such as capital adequacy requirements set forth by the Basel Accord.

The regulatory authorities would need to step up their monitoring efforts, including inspections of individual financial institutions, to replace the strict regulations. Furthermore, review must be performed on accounting standards, on which an accurate understanding of the actual state of financial risks rests. Sound lending practice by financial institutions is closely connected with reform of the state-owned enterprises, which are the major borrowers from the financial institutions in the western region. Therefore, state-owned enterprise reform is of crucial importance as this would also be a benefit to financial risk control.

13.1.3 Risk control that addresses growing system risks

With changes in the financial system and financial deregulation, it is increasingly difficult for the government to clear the bad loans created by the financial institutions on its responsibility and at its expense. The government needs to make efforts to disperse system risks and to develop deposit insurance and other systems (i.e. safety nets) designed to avert system risks so that no disruption of economic transactions or negative impact on economic growth and development is triggered from the instability of the financial institutions.

The financial system of China today is dominated by indirect financing, with banks serving at its core, while direct financing via securities exchanges has made little progress. For this reason, virtually all risks associated with the actual economic realities are borne solely by banks and other financial institutions. In achieving more dispersed risk distribution to safeguard against overall system risks, it is essential to strengthen the direct financing segment and to allow increased risk dispersion with a broader range of investors bearing risks in small amounts and with less risk to be borne by the indirect financial players; i.e. banks.

13.1.4 Risk control that addresses policies for economic growth

Given China's current state of economic development, financial institutions are expected to play a certain role in the concentration and distribution of funds under the execution of economic development measures. Likewise, financial institutions are expected to play a significant role in gathering funds for the development of the western region where the fiscal resources are limited.

However, the concentration of policy-based funds for economic growth could at times come into conflict with the fund allocation based on the pricing mechanism. A wrong approach taken for the concentration of funds could hinder proper financial function and might introduce new credit risks to the financial sector. Furthermore, given the current situation where arbitrariness and personal considerations in fund disbursement under the old regime are not yet completely dispelled, financial transactions performed under policy-related instructions might resurrect this corrupt practice.

At the present evolutionary stage of China's financial system, seeking economic efficiency using the functions inherent in the financial system is of utmost importance. On this premise, financial tools should be used to support the economic policy while making sure they are in harmony with risk control by financial institutions.

The capital adequacy rule based on risk weights has already been introduced to China as a financial risk control technique. This rule may be used to assess the concentrated allocation of funds to the western regional development by commercial banks in an attempt to strike a better balance between risk control and development policy.

13.1.5 Risk control that addresses automation of the financial sector

In recent years, information technology (IT) has advanced in leaps and bounds. In Japan, Europe, and the United States, IT has realized automation of financial services. Moreover, electronic banking aiming to deliver new products based on IT is making rapid progress. In China, the automation of financial administrative functions and the use of computers for implementation of financial services have tremendously increased. Looking ahead, penetration of electronic money is on the horizon. Furthermore, the use of IT (i.e. computer systems) for ALM and other risk control techniques at financial institutions needs to be taken to a higher stage.

Plans for the western regional development also call for an improved environment for bank ATM users and increased automation for financial infrastructure such as promotion of on-line connections. The financial automation and related projects for the western region, which will be able to take advantage of newer, more advanced technology available to latecomers, should be implemented with special care as they may become model projects for the whole of China.

Automation at small and medium financial institutions should be promoted based on the collective approach where the automation initiative will not be undertaken separately by each financial institution but related development and arrangements will be made jointly. This is because automation requires sizable investment in equipment - albeit inexpensive compared to the past.

In an effort to catch up with rapid technological advancement, financial institutions have been preoccupied with the efficiency that IT brings about while they pay less attentions to technological details and security concerns, which are difficult to understand by non-technicians. Security measures relating to automation have to be properly adopted.

The basic key to risk control relating to automation lies in the enhanced measures to prevent accidents and incidents. Such measures must be administered from the aspects of technology, systems, and equipment. Additionally, a well-organized management structure within the financial institution is needed. In particular, managers should learn the technological specifications and take the initiative in implementing risk controls rather than relegating security-related tasks to specialists.

In settling disputes and other matters, the standards for dispute settlement need to be clarified. A model law for electronic fund transfer has been under preparation for many years by the UN Commission on International Trade Law (UNCITRAL). A few nations have already enacted legislation based on this model law. Appropriate legislation has to be in place in preparation for the spread of electronic banking.

13.2 Financial risk control by financial institutions

Risks faced by financial institutions include risks which accompany financial transactions such as credit risks, market risks, and liquidity risks. Other risks include those which arise from business management of financial institutions such as legal and managerial risks.

13.2.1 Introducing a team in charge of ALM

As stated earlier, ALM technique should replace the conventional technique for the identification of risks on the balance sheets. To achieve this, it is crucial for the financial institution to set up a committee or department which discusses ALM on a comprehensive basis. The ALM committee/department is responsible for identifying and examining measures against financial risks based on ALM and turning these measures into concrete action.

The ALM committee should directly report to senior managers and be authorized to collect required information from any department at all times. If an ALM department is set up, it should also directly report to senior managers. Even if the ALM department is ranked equal to ordinary operating divisions, the department needs to be given the power to collect information from any department at any time.

13.2.2 Improving the check and control structure of credit risks

For the prevention of bad loans, bringing improvement to the check and control structure of credit risks is crucial.

When extending loans, it is important to judge the borrower's ability to repay the debt. For this, a structure allowing proper credit checks on the borrower has to be in place including qualitative and quantitative analysis, assessment of a fund usage plan, and appraisal of collateral.

To prevent high-risk credit brought out of political considerations, responsibility of senior managers has to be clarified while the power of the credit evaluation department has to be adequately empowered. Furthermore, with respect to credit approval process which will be made on the basis of credit evaluation, the level of credit approval authorities has to be expressly set forth, and the credit approval must be made based on the prescribed authority.

After the execution of loans, it is important to keep track of the operating performance of the borrower and to keep up with credit control efforts at all times. Credit control may be performed by a section that extends lending such as a credit department at headquarters or a credit department or a section at branches.

An auditing department needs to be set up independently from the business execution sections in order to ensure proper internal auditing and risk controls. Given the importance of internal auditing, it would be appropriate if the credit auditing department along with the inspection department (discussed below) would be placed directly under senior management of the financial institution.

13.2.3 Introducing internal inspection structure

To ensure proper management of financial risks, it is important to establish an inspection structure to confirm that the operations of a financial institution are carried out in full and proper compliance with operating rules. Other important duties to be performed by the inspection department include inspections focusing on operational errors and wrongdoing by employees and criminal manipulation of transactions by third parties.

It is desirable that the inspection department also conducts inspections focusing on risk controls relating to trade and derivative transactions, dual control over money handling, and unauthorized use of computers and illegal access from outside.

13.2.4 Preventing moral hazards

In China, the head office and branch of a bank have typically operated under pressure from influential figures of the province or the city where the bank is located, and they often find themselves forced to decide and execute loans under their influence. Being a responsible financial institution, the bank must perform careful credit assessment and make lending decisions in strict conformity with the lending standards employed by that bank for all loan cases including loans for projects with the involvement of provinces or cities.

It is essential that credit is extended based on the evaluation and decision-making procedures of the department or committee authorized by the lending rules of the bank instead of arbitrary decision and evaluation by senior management. To prevent financial moral hazards, it is crucial to establish managerial ethics and to enforce full compliance with the lending rules.

IV. Reforming complementary systems of the financial sector

IV Reforming Complementary Systems of the Financial Sector

14. Optimizing investment promotion measures

14.1 The objective of optimizing investment promotion measures

The main investors in the western region are currently played by the public sector. However, capital injections from the private sector including the foreign investors are expected to increase importance because of the fiscal pressures. In order to stimulate the private sector and the foreign investment, it is necessary to expand preferential measures, provide investment-related services including information delivery, improve the investment climate, and enhance investment promotion strategies in each province, municipality, and autonomous region in the western region.

14.2 Raising the profile of the western region

(1) Active dissemination of information on the western region

Investors have pointed to shortcomings in the transmission and provision of information on the western region. The various provinces, municipalities, and autonomous regions have set up websites providing basic information on the investment climate. However, the content and degree of information provided varies, and investors encounter problems in deciding upon the investment sites. The Leading Group for the Western Development of the State Council and the Ministry of Commerce provide introductions to investment projects in the western region, but these amount to simple lists of projects. Consequently, investors also have difficulties to acquire useful information disclosed by the central government in the short-term.

In coming years, the various provinces, municipalities, and autonomous regions of the western China have to accelerate the investment promotion services and work towards their steady implementation. In this endeavor, establishing organizational structures to ensure the provision of such services throughout the province is critical. In addition, investment promotion services that cover the entire western region should be planed. These services shall complement those implemented in each province, municipal, and autonomous region.

In terms of specific policies, investment promotion organization for the western region may be established. This organization does not have to be newly created. For example, the organization can be a branch of the Foreign Investment Administration of the Ministry of Commerce. The immediate functions of the organization include providing information on the western region to foreign and domestic investors, consulting services, and undertaking of the basic studies.

Furthermore, some offices may be established in the industrialized countries where the potential investors exist. While setting up an office by each province, municipality, and autonomous region in the western region may be financially not feasible, establishing a joint office for the entire western region may be feasible for delivering investment-related information.

(2) Developing a branding strategy

In spite of efforts by the various provinces, municipalities, and autonomous regions of the western region to disseminate investment-related information, if investors and/or corporate representatives are unable to get a clear picture of the "selling points" and "strengths" of a particular area when viewing the websites or pamphlets, then western China shall retain its low ranking as an investment destination. It is essential to deliver clear messages that the western region has advantages as an investment destination. Each province, municipality, and autonomous region in the western China is advised to identify its competitive industries and industrial centers. Then it has to adopt a "branding strategy" that markets such promising industries as a brand through advertising on websites and in other introductory materials, targeting at potential investors.

(3) Attracting investors through investor-oriented activities

In the past, the government of the various provinces, municipalities and autonomous regions in the west took a lead in investment promotion such as disclosing project lists. By contrast, some provinces and municipalities in coastal regions have Japanese-speaking personnel in dedicated organizations undertaking investment promotion. There are also examples in which high-ranking officers in a regional government or Development Zone Administrative Commissions are directly approaching to the potential investors.

For an effective investment promotion, the regional governments in the west must change their stance to more investor-oriented. To realize this, it is critical for organizations and individuals responsible for investment promotion to have more opportunities for exchanging information and discussion with the potential investors. Information exchange should be promoted through investment seminars, e-mail, and websites.

14.3 Expansion of investment-related services

Providing information for the potential investors as discussed above can be put into actions in a short-term problem while a framework for investment-related services, including investment incentives, has to be established in a mid-term. Following steps are recommended to take to establish the framework.

In the first step, a working group for the foreign investment promotion should be established. The working group is comprised of local enterprises and experts and is assisted by specialists dispatched by the central government. The establishment and operation of such working groups would enable local players to share basic ideas on the foreign investment promotion.

In the second step, the local governments from the western region shall hold investment promotion seminars in major costal cities where foreign-affiliated companies are concentrated such as Shanghai and Guangzhou.

In the third step, a more focused and specific measure should be taken in an aim to yield conclusions of investment contracts and setting up new foreign enterprises.

14.4 Expansion of preferential policies and improvement of the investment climate

Preferential policy options to encourage investment in the western region could include (1) prior implementation of deregulation policies within China and (2) introduction of deregulation policies that have already been put into effect in the coastal region. The latter includes the application of a reduced corporate income tax rate of 15 percent for all foreign-affiliated companies operating in Special Economic Zones. In the western region, this reduced tax rate applies only to foreign manufacturers operating in Economic and Technical Development Zones. Applying the same criteria to Economic and Technical Development Zones in the west as are used in Special Economic Zones in the east would be effective in raising investment incentives.

However, some studies report that preferential policies on investment alone are of limited efficacy in attracting investment. Accordingly, expansion of preferential measures has to be accompanied by enhancement of the overall investment climate. It would also be efficient to undertake investment promotion activities by utilizing the information and networks of the private sector. Mechanisms in which established enterprises in the west take the role of information providers should be considered. One option includes payment of commissions by the local government to companies which successfully cooperate in the investment promotion.

15. Fiscal and tax reforms

Public finance and tax take as important roles as the financial sector in facilitating the western development. In developing the role of the former, the system and policies of public finance and tax have to be reformed from the aspects of income and expenditure.

15.1 Introducing tax grants into the tax allocation system

15.1.1 The need for reform of the tax allocation system

To promote the western development, local governments require larger financial resource. However, it is difficult for the local government to acquire larger financial resource under the current tax allocation system between the central and the local governments. In a first step, adjustments have to be made within the confines of the existing system.

Reform of the tax allocation system has aimed at introducing objective criteria and eliminating artificial factors, negotiation, and political powers. The objective criteria have incorporated necessity for fiscal disbursements in each region. However, there are no national standardized criteria for disbursements, which are based on the demand of the local residents. The level of the bargaining power still affects decision making on the scale and scope of subsidies, investment projects, and special-purpose funds.

15.1.2 Outline of the tax grant to the regional governments

Many countries of the world, particularly the industrialized nations, have combinedd tax grants and subsidies to the local governments with the tax allocation system. Similar to the tax allocation system in China, the tax grants are often disbursed to the general account of the local government without specifying the usage. On the other hand, regional subsidies are usually disbursed from the special fund of the central government. These regional subsidies as often seen in the industrialized nations resemble China's special-purpose funds, which are allocated by the central government to local government units. In short, the tax allocation system currently employed in China already incorporates elements of the tax grants and subsidies to the local government.

The tax grant system reflects the concept of a fiscal guarantee designed to ensure that the local government provides a minimum level of administrative services to residents based on the national minimum principle. The tax grant system functions according to the following process: (1) calculating the amount of fiscal fund necessary to maintain the minimum service after identifying the services that need to be extended to the residents in each administrative boundary; (2) calculating the amount of tax grant from the difference between the necessary fund or theoretical expenditure as calculated in (1) and revenue of each local government; (3) identifying the fiscal source, which is transferred from the central or higher level of the local government; and (4) adjusting (1), (2), and (3) in response to changes in the content and level of administrative services reflecting economic growth of the region.

To ensure a stable and systematic supply of treasury funds in the local government in the western region, a systematic reform that standardizes reallocation of the fiscal fund between the central government and the provincial governments has to be implemented including the introduction of the tax grant system. Given the continuity of the present system and the feasibility of systematic reforms, full-scale introduction of the tax grant system is likely to be difficult in the short term; nonetheless, adjustments to the tax allocation system that are based on the concepts of tax grant, i.e. the application of nationally standardized criteria for administrative services and fiscal outlays, is of critical importance in the short run. The most important point of the reform is to ensure that decisions on disbursement of the fiscal fund to local government are made based on objective and uniform criteria throughout the nation. This will guarantee the required minimum expenditure of the local government and allow people to receive the same basic administrative services no matter where they live.

15.2 The division of public and private-sector roles in investment

15.2.1 Financial constraints of the local government

Public finance has a major role to play in funding the western development. However, the cash-strapped state of central government finances means that treasury funds are insufficient to cover all financial needs. Moreover, in a bid to accelerate economic development and catch up with more advanced regions, local governments, particularly in the economically less developed west, are apt to invest in economic development, especially in industrial development projects. This has caused not only the sacrifice of the public functions and administrative services for the residents but also leaving behind of the weak social infrastructure. Consequently, these have resulted in delay in economic development.

To expedite the western regional development, various funds have to be mobilized and channeled into the region. In order to achieve this, the respective roles of public and private sectors must be clarified; especially the demarcation as the financial suppliers for the industrial development and the construction of industrial infrastructure have to be clarified.

15.2.2 Private sector-led industrial development

Among the public operations, those that are profitable need to be transferred into the hands of the private-sector while the government focuses on unprofitable operations for the public benefits, i.e. on the public services for the residents. Likewise, the financial resource of the local government should not be spent on the economic development. Such responsibility should be handed to the private sector while the local public funds are concentrated on the public services. In concrete terms, the financial resources of the government (the central, the provincial, and municipal governments as well as autonomous regions) should give priorities to environmental conservation, human resource development, health and sanitation. The use of fiscal resources for infrastructure development should be limited to projects which highly serve the benefits of the public and present difficulties in fund collection. Meanwhile, investment in industrial development should be directed to the private sector, and the direct governmental funding should be kept to a minimum. To achieve this, the idea that governments are responsible for promoting investment in economic development must be discarded with this role assigned to the private sector. At the same time, various measures have to be put in place so as to encourage private investment in the western region.

15.3 Improving the quality of government spending on basic residential services

15.3.1 Problems with the provision of administrative services by distal government units

Local governments are under obligation to provide administrative services to the general public. Such services include education, health, and environmental conservation. Currently, these administrative services are provided by distal government units; i.e. at the township level. However, since local governments, particularly the distal township governments, are likely to inject fiscal resources into economic and industrial development projects such as construction of industrial estates. Consequently, they lack in sufficient funds for the public services. This result in widening regional economic disparities because necessities for the social and human resources are discarded such as education and medical care while the potential for long-term growth are diminished. Moreover, aggressive levies on the education and health services have invited oppositions from the farming communities. The root of such problems lies in the fact that distal government units start out with limited fiscal resources and cannot guarantee sufficient administrative services.

15.3.2 Upgrades within the existing system as an interim measure

At the present time, with no hope of any significant increase in local government funding, one emergency measure is grading up of the level of the local government which is responsible for budgeting. The financial sources on compulsory education, healthcare services for the rural communities, the administrative expenses of distal government units, and, at the very least, wages of the public officers are recommended to be secured at a higher level, i.e. from the township level to the county level, or even to the municipal or provincial level. Another option would be for the necessary fiscal resources to be jointly born by various levels of the governmental units; from distal government units to the upper governmental units.

Such changes afford a number of merits. Firstly, the scope for utilizing independent financial resources widens significantly without any change to the existing revenue allocation system. Secondly, higher level of government organs has a greater awareness than distal governments is likely to be more disciplined to adhere to fiscal restraints, which will serve to prevent the diversion of budgetary funds and aggressive revenue collections from the villagers. Thirdly, incremental upgrades, i.e. from township to county, from county to municipality, from municipality to province, will help to avoid the confusion that occurs with changes in the fiscal system. This principle accords with the reform of the fiscal policy.

Salary payments for teachers in the compulsory education system were in fact upgraded from the township to the county revenue level in 2004. Financial resources for compulsory education will need to be raised further in the future, to the municipal and to the provincial levels. Likewise, spending on health and wages of the public employees that are currently paid by the township government has to be gradually upgraded to the county level, then to the municipal and provincial levels.

16. Human resource development for the financial service

16.1 Human resource development within organizations

Recent progress in financial reform has brought about fast-paced changes in the content and flow of the financial services. The employees of financial institutions are required to respond rapidly to such changes and to enhance their capacities. Accordingly, providing re-education and training opportunities with their employees are an important agenda for the financial institutions. It is recommended that the financial institutions to establish internal systems and programs for the capacity building of their personnel. This is particularly critical for the western region where the banking practice is less developed than eastern regions. Followings are the list of the systems and programs, which the financial institutions can introduce and/or expand for the human resource development.

Development of service regulations for employees
Development of work manuals
Introduction of grade and a promotion examination systems
Development of in-house training systems
Strengthening of on-the-job training (OJT)
Introduction of external study programs
Dispatch of employees to seminars and/or training sessions

16.2 Human resource development at external organizations

(1) Utilizing financial, economics, and banking departments of universities

There have been comparatively major expansions to financial, economics, and banking departments at universities in recent years. Small and medium size financial institutions in the western region should strengthen linkages with such departments not only for recruiting their graduates but also for utilizing knowledge accumulated in the departments.

(2) Utilizing university business schools

In promoting the financial industry in the western region, business schools for postgraduate students need to be further enhanced. Small and medium financial institutions should make use of these schools which are expected to equip the students with highly specialized knowledge on financial services including new lending methods, the latest financial products and techniques such as derivatives, securities, and insurance.

(3) Establishing an education and training system for small and medium financial institutions

Although small and medium financial institutions require taking actions on human resource development, they face certain limitations unlike major financial institutions. It is suggested to establish a network for educating and training personnel of the financial industry in the western region and to expand and to improve education and training programs targeting small and medium financial institutions.

16.3 Encouraging personnel exchanges

Currently, some level of personnel exchange between head office and branches is practiced at limited financial institutions such as the China Construction Bank, but, this practice remains small-scale. Promoting inter-personnel exchanges between head office and branches would contribute to rectifying disparities in the level of services provided centrally and locally and to resolving personnel shortages in the western region.

However, some employees may show negative reactions to the transfer to a remote area. Some measures are necessary to overcome such problems for the large scale and smooth implementation of the personnel exchange system. Followings are necessary to be considered in the process of establishing personnel exchange system.

(1) Reforming personnel transfer system

A personnel system should be changed in a way to provide a sense of security with the employees who are to be transferred. One measure is to require personnel to have undertaken a regional posting for a certain number of years in order to qualify for promotion. Another measure is to establish a rule for the transferred personnel to return to the original office after certain duration of the regional posting.

(2) Maintaining city registrations

Employees who were posted to different cities immediately after graduation reportedly lost their city registrations in some cases. Such problems should be avoided in implementing the personnel exchange system.

(3) Allowance, residence, and sibling education

A welfare system should be established for the employees to receive some benefits, which look after issues of an allowance, housing, and sibling education during their transfer.

17. Reforming regulatory system for the regional development and finance

17.1 Establishing a legal structure and principles governing policy formation and implementation

17.1.1 Organizing the legal structure

Administrative regulations play a crucial functional role in China's legal system, but expecting administrative organs to prescribe and enforce the established regulations is problematic. If the objective is to establish a "fair, equitable, and prescriptive/enforceable legal system", efforts to improve the "laws" as defined in the Legislation Law are needed. The legal structure of laws and regulations that were enacted before the enactment of Legislation Law of the People's Republic of China (March 15, 2000) must be reorganized. At the same time, new laws and regulations have to be formulated in accordance with the legal structure prescribed in the Legislation Law.

17.1.2 Adhering to the principle of "advanced legislation"

In recent years, China has been attempting to follow the principle of "governance according to laws". Nevertheless, there are no laws that set the framework for the western development policy, which lasts for fifty years and exercised under instruction from the top tiers of the policy makers. The administrative organs (the State Council, provincial and local governments, local committees) are eager to establish administrative and regional regulations despite the absence of the law as defined in the Legislation Law. This situation is a distortion of the principle of "advanced legislation"; i.e. "governance according to laws". Compliance with the principle of "advanced legislation" is a prerequisite to the "governance according to laws".

17.1.3 Improving legislation for regional development: establishing the Basic Law on Regional Development (tentative name)

China does not have a comprehensive "law" on regional development. The policy-decision process for the western development clearly reveals weakness in the legal platform. Except for the adoption of the 10th Five-Year Plan, the entire western development strategy is established and implemented by documents of codes in the names of "notification" or "opinion".

Regional development requires long-term continuity and a substantial fiscal support. There is an urgent need to establish a stable legal platform, i.e. "laws", in order to ensure stability and consistency of the national policy and to guarantee transparency.

One option for developing the legal structure of the regional development is formulation of what is termed the Basic Law on Regional Development. It sets forth principles of drafting, decision-making, and implementing a regional development policy in all relevant departments including purposes of the regional development policy, methods for drafting regional development plans, a framework for resolving policy issues, policy implementation methods, supervision mechanisms for policy implementation, and methods for adjusting budgetary allocations. Following the Basic Law, administrative regulations, regional regulations, and department or committee rules should be formulated. Specifically, administrative regulations to be issued by the State Council include "regulations for restructuring of industry in the western region" and "regulations for economic development of the northeast region". On the other hand, the regional regulations and department or committee rules set forth specific policies based on actual conditions in the target region as well as detailed and definitive policies targeting individual sectors and/or provinces.

Another option would be establishing regional development laws for each region such as "western development law" and "northeastern region development law". The Legislation Law states that items to be set forth by "laws" include "fundamental economic system and basic systems for fiscal, tax, custom, finance, and foreign trade" and "other matters which must be enacted by the National People's Congress and the Standing Committee". Considering the scale and wide coverage of area, the regional development deserves a legal platform supported by a "law" even if its scope is not national.

However, the second option is likely to take a considerable time in countries with a landmass as vast as China's. It requires the National People's Congress to discuss the purpose and methodologies for the regional development while adjusting distribution of the regional benefits and prioritizing the needs for the regional development. In view of the urgency and importance of development plans and the legal structure as stipulated by the "Legislation Law", the first option, i.e. establishment of the Basic Law on Regional Development, is considered to be practically more plausible.

17.2 Development of financial legislation

17.2.1 Strengthening the legal platform of policy-based financial institutions: establishing the Basic Law on Policy-based Financial Institutions (tentative name)

In the field of "policy-based finance, one probable option is the introduction of "institutional banking", which supplies long-term, low-interest concessional funds to specific development projects, agricultural infrastructure, environmental conservation, and small and medium enterprises (SMEs) in backward areas of the western region. In addition, the establishment of policy-based regional financial institutions dedicated to a regional development is another subject, which is worthy of consideration. In order to provide existing government banks with a firmer legal platform and to develop a legal platform affording the same level of stability and regulatory authority for the "institutional financial institutions" and "policy-based financial institutions" that may be developed in the future, the establishment of the Basic Law on Policy-based Financial Institutions (tentative name) is proposed. The proposed Basic Law sets the legal framework of the policy-based financial institutions, regulating purposes, establishment procedures, capital allocations, business scopes, fund-raising, supervision, reporting, and responsible administrative organs.

17.2.2 Developing and improving the legal system governing industrial finance

(1) Improving the transparency of finance and accounting

In order to enhance industrial finance, an issue of improving the transparency of enterprises, the users of the industrial finance, has been pointed out. The corporate financial and accounting audits have to be strengthened, and this improves fund-raising capabilities of enterprises. Articles 211 and 212 of the current Company Law state that a fine of between RMB10,000 and RMB100,000 may be imposed on enterprises in the event that they keep two books or distort financial and accounting reports (it goes on to state that criminal liability shall be imposed if such action constitutes a crime.). The Company Law also states that an illegal income shall be confiscated, and a fine of up to five times of the illegal income shall be imposed in the event of illegal transfer of company assets into a bank account bearing a different name. However, this penalty would not be sufficient in view of the recent rises in income that have accompanied by economic development. Raising fines to a level at which they become genuinely punitive will likely serve efforts to increase the transparency of corporate finance and accounting.

(2) Expanding eligibility to issue private placement bonds and corporate bonds

Corporate bonds are currently only permitted to be issued by listed companies. Widening eligibilities to issue company bonds and private placement bonds are suggested in order to allow companies greater scope to procure long-term, fixed-rate funds from the market. This change will require the easing of the conditions of corporate bond issuance as prescribed under Article 161 of the Company Law. In bringing in the benefit to the western region, easing requirements on minimum net asset and cumulative value of issued bonds will be essential because majority of the target beneficiaries would be small and medium enterprises. Another option would be to separate the clauses within the Company Law that apply to large enterprises from those apply to small and medium enterprises while the latter is to be added or amended.

A priority issue in the private placement bonds, which are purchased by relatively few investors, is to increase transparency in company and management information by making enterprises accountable for their business and financial affairs. Moreover, giving bond buyers the right to request a company audit under certain conditions, in addition to the audits conducted by the State, would help to breed transparency and reliability.

(3) Policy-based financial institutions specializing in small and medium enterprises (SMEs)

In the financial sector targeting SMEs, institutional finance whose financial source is funded by the government has an enormous role to play in the area where the commercial finance is not available particularly for business startups and the provision of emergency funding. Therefore, institutional finance, combining central and local government finances and financial function, targeting at SMEs is recommended to be established. For this to be realized, it is necessary to enact the "Basic Law on Policy-based Financial Institutions (tentative name)". Then the "regulation for banking system for small and medium enterprises" is established as an administrative regulation under the "law on the promotion of small and medium enterprises".

17.2.3 Legislating the financial disclosure of financial institutions

It is desirable that financial institutions will make regular annual financial reports available to the general public to reinforce depositor protection. Therefore, the clauses pertaining to financial accounting reports contained in Articles 55 and 56 of the Law on Commercial Banks are suggested to be amended and to make the general disclosure of financial status mandatory, prescribing content requirements, the timing, and method of disclosure.

17.2.4 Strengthening penalties over illegal financial dealings

Section IV of the Securities Law of the People's Republic of China provides detailed provision on prohibited financial activities including false reporting, the spreading of misleading rumor, virtual trading, and insider dealing. However, Chapter 11, which covers "legal liability" in the event of an infringement, prescribes only the amount of fines without imprisonment punishment. The chapter merely states that "criminal liability shall be pursued according to laws in case of an offense constituting a crime".

It is widely believed that economic crimes committed in a market economy should carry strict penalties in order to maintain the paradigms of the economy and of the market, but the punitive clauses of the Securities Law of the People's Republic of China are inadequate as "property penalties" even with respect to the amount of fine. Moreover, given the gravity of economic crimes committed in a market economy, the law should surely include "freedom penalties" (punishments that restrict freedom of action, like imprisonment). Similar penalties should also be incorporated into the Insurance Law, the Trust Law, and the Law on Banking Regulation and Supervision.

17.2.5 Regulating the legal structure governing Commercial Banks and Insurance

The Law on Commercial Banks and the Insurance Law abolish regulatory distinctions by ownership such as public and private to cover comprehensively. However, it is unclear how these laws relate to the Regulations on the Management of Foreign Financial Institutions and the Regulations on the Management of Foreign Insurance Companies. The Laws should be amended and state the relationship between the foreign owned enterprises and these Regulations.

Furthermore, regulations on the China Securities Regulatory Commission (CSRC) have been incorporated into the Securities Law whereas the China Banking Regulatory Commission has independent regulations. Such inconsistency will cause confusion in the legal system. The two commissions should be regulated in the same legal structure.

17.2.6 Development of legal structure governing PPP

Project financing in PPP (Private Public Partnerships) is formulated on the basis of complicated contracts. In order to guarantee validity and enforcement of the contract, the development of a legal system is necessary governing civil contracts, the guarantee system, realty, civil protection, civil enforcement, auctions, bankruptcy, etc. China has a fairly complete set of laws governing contractual activities, but many aspects still require improvement. The biggest problem is the inadequate provision regarding realty in the "The General Principles of Civil Law". To improve existing circumstances, a law of realty has been drafted and is under deliberation in the Standing Committee of the National People's Congress (SCNPC). A major progress is observed in this draft, which clarifies conditions, scope and grounds in respect of content, acquisition, efficacy and annihilation for each form of rights. Furthermore, it covers major legal matters closely relating to project finance including property rights, building site use rights, easement, mortgage deeds, right of pledge, and possession. It is hoped that this draft law will soon be enacted.

Article 268 of the Civil Procedure Law states that the people's court shall not grant a claim for civil enforcement based on a verdict delivered by a foreign court if the enforcement is in breach of sovereignty, national security, or social interests of China with reflection to the international treaties which China has concluded or to which China is a party and the principle of mutual reciprocity. This regulation allows foreign verdicts to be nullified based on the final judgment by the people's court in some cases. This rule has to be justified by the existence of a neutral, impartial and reliable judicial system. Further, the civil enforcement rules prescribed in the Civil Procedure Law have to be improved by including punitive measures.

17.2.7 Legal system development for financial risk management

(1) The introduction of legislation to combat legal risks (protecting the contractual rights and obligations of financial traders)

As stated in the previous section concerning the development of PPP legislation, laws containing general clauses on claimable assets, guarantees, contractual violations, and breaches of contract have been developed in respect of contractual protection. The law of realty is expected to be enacted soon.

(2) The introduction of legislation to combat credit risks (default risks)

A legal system for the credit risks requires laws governing civil protection and civil enforcement. As has already been stated, some rules have been set forth within the Civil Procedure Law, but the concerned clauses are necessary to be developed into separate laws, i.e. independent "Civil Protection" and "Civil Enforcement" laws. Current rules on the compulsory enforcement do not classify the type of property to be seized whether in the form or money, real estate, or movable assets. Further, the "title of debt" for implementing compulsory execution needs to be reorganized into a more readable form. Japan's civil enforcement law contains clauses on the repossession of real estate held as collateral in the forms of auction or forcible collection of profit earned from the real estate. Such rules can be incorporated in the "Civil Enforcement Law" in China. Moreover, as stated in the preceding paragraph, the establishment of punitive clauses will also be necessary.

Clauses pertaining to corporate bankruptcy are scattered across the Company Law and the Principles of Civil Law while the content of the existing "Bankruptcy Law" is only applicable to the state-owned companies. Accordingly, it is hoped that new bankruptcy law covering all corporate bankruptcies be formulated and that laws governing bankruptcies be unified into one.

V. Action plans for “Financial system reform for the western region development”

V Action plans for "Financial system reform for the western region development"

18. The structure of action plans and implementation framework

18.1 The structure of action plans: principles and strategies

As the concrete measures to realize the financial system reform for the western region development, action plans are designed based on three principles. These action plans are further formulated under five strategies.

18.1.1 Three Principles

Principle 1: Overcome underdevelopment

Three policy areas are recognized as significant: regional development policies for underdeveloped areas; industrial policies for re-structuring sectors with low productivity; and social development policies for poverty eradication. Action plans for financial system reform aim to accelerate the progress and enhance the achievement of these policies areas.

Principle 2: Utilize financial functions

Financial system reform facilitates appropriate distribution of resources where market mechanisms fail to function effectively through enhanced circulation mechanism of financial resources.

Principle 3: Establish a legal infrastructure

The establishment of the concept of sound social credit should be considered as the basis of the development. To achieve this state, it is proposed that the rule of law be established; that development of finance and development related legal structure be promoted; that capacity of supervising institutions and regulatory systems for the financial sector be strengthened so as to reinforce the financial risk management; that relevant data be compiled and managed; and that human resources be fostered to support the development of financial sector.

18.1.2 Five Strategies

Strategy 1: Reform institutional finance

Redefine policy-based lending and restructure policy-based finance system in order to meet the needs of the regional and agricultural development in the western region.

<u>Suggested action plans</u>

Action plan 1: Reform the policy-based lending system
Action plan 2: Set up policy-based finance system to promote western development
Action plan 3: Develop institutional finance for agricultural development

Strategy 2: Reform rural finance

In view of the fact that the "three rural issues" are China's top political agenda, the reforms of Rural Credit Cooperatives that are currently proceeding on a trial basis should be accelerated. At the same time, new cooperative finance instruments should be developed as well as strengthening microfinance.

Suggested action plans

Action plan 4: Reinforce the reform process of Rural Credit Cooperative
Action plan 5: Pilot the credit financing through the Agricultural Producers' Association
Action plan 6: Strengthen microfinance in rural areas

Strategy 3: Foster regional banks

By fostering regional banks as core institutions among regional financial institutions, financial services to serve for the community needs should be expanded and improved.

Suggested action plans

Action plan 7: Foster financial institutions and expand financial sector that serve for the community needs

Strategy 4: Diversify project financing

To respond to increasing funding demand for a diverse range of projects in the western region, the necessary institutional reforms should be undertaken by diversifying financing instruments and project methods.

Suggested action plans

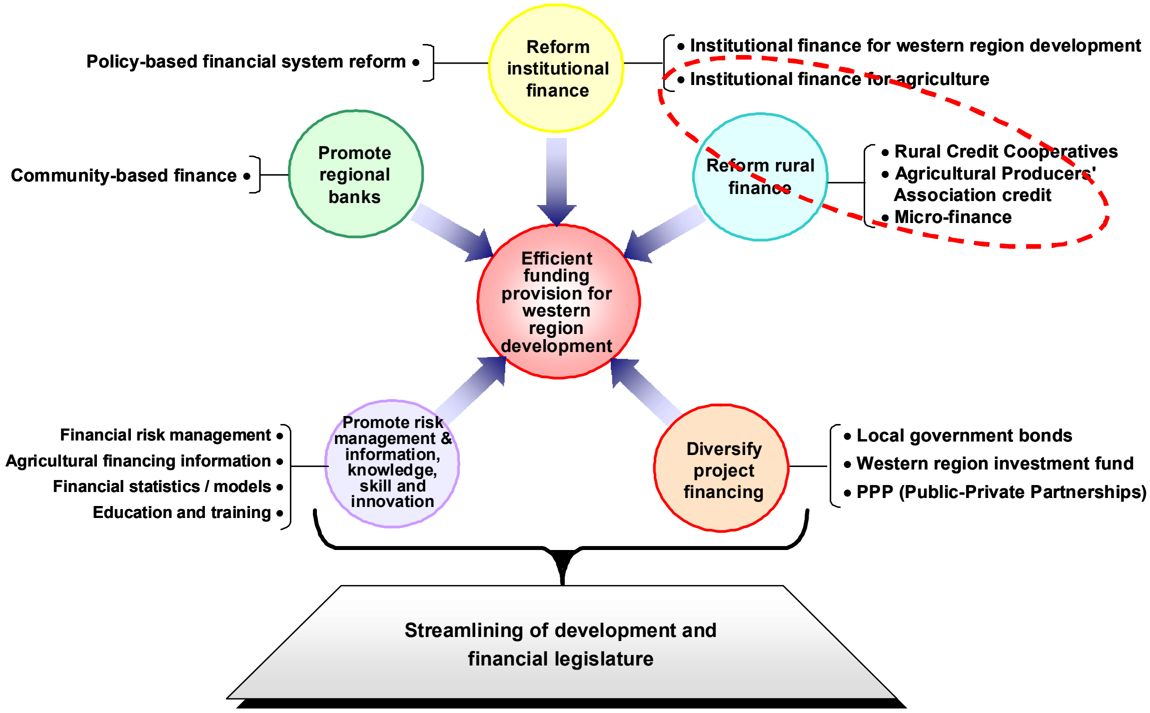
Action plan 8: Issue local government bonds
Action plan 9: Establish regional financial centers in the western region
Action plan 10: Full-scale facilitation of PPP (Public-Private Partnership)

Strategy 5: Reinforce strict financial risk management and renew finance related information, knowledge, and skills

In response to the prospect of rapid deregulation progress of the financial sector, financial risk management system should be restructured and facilitated drastically, as well as information, knowledge, and skills related to financial management should be renovated.

Suggested action plans

Action plan 11: Develop a financial risk management system
Action plan 12: Develop industrial finance information center functions
Action plan 13: Develop financial statistical data and utilize economic models
Action plan 14: Foster human resources for the financial sector in the regions



Source: JICA Study Team

Figure 18-1 Action plans for the financial system reform for the western region development

18.2 Institutional framework for implementation of action plans

Step 1: Facilitating of the institutional framework for implementation of action plans: establishment of an investigative commission on financial system reform in the western region development

It is recommended that "an investigative commission on financial system reform in the western region development (task force)" be established at the time of the completion of this study. The commission can examine the action plans recommended in this report and flesh them out as policy measures in line with China's current situation.

This investigative commission (task force) should comprise members from relevant organizations, and the People's Bank of China (PBC) and the Leading Group for Western Development of the State Council should be jointly responsible for running the Secretariat. It is suggested that the investigative commission examine the recommendation of this report; that it compile recommended policy measures for an investigative commission report; and that the report be submitted to the premier of the State Council for further procedure.

Step 2: Upgrading of systems to facilitate further progress in financial system reform: establishment of the investigative commission on financial system reform

In light of the trend toward financial deregulation and the current financial administration system with multiple systems simultaneously in place, the establishment of the "investigative commission on financial system reform (task force)", based on the experiences of the investigative commission on financial system reform in the western region development, is considered to be an adequate measure.

This investigative commission should analyse the issues relating to financial system reform, including the future of policy-based finance and regional development financing, develop recommendations for reform and, submit them to the premier of the State Council as an opinion at an adequate timing. The investigative commission should comprise scholars and researchers in the field of finance as well as personnel from financial administrative organizations and, where necessary, the officers of financial institutions should be requested to be co-opted. Moreover, support should be provided to undertake any necessary research from the Development Research Center of the State Council and the Chinese Academy of Social Sciences.

Working groups on policy-based finance, commercial finance, SME finance, agricultural finance, regional development finance, securities, and insurance, etc, should be established under the investigative commission. The regional development and other relevant working groups should take over the work mainly done by the investigative commission on financial system reform in the western region development. At the same time, the working group will handle the remaining problems for the development policies for the underdeveloped regions.

Improving transparency is a key factor of the guiding principles for administrative management. Sharing the possible policy options and soliciting public comments through a financial system reform investigative commission is considered to be the most effective means for the securing the transparency of government financial administration in response to the demand for openness and accountability of the policies.

Step 3: Restructuring of financial administrative systems: establishment of an investigative commission on financial administrative system reform

As financial deregulation advances, the need to establish a financial system that is commensurate with a market economy will become increasingly pressing. China will have no choice but to effect the gradual removal of the dual financial framework that segregates domestic and international concerns. In order to address these changes, it will also become necessary to restructure the current situation with multiple financial administrative systems. Therefore it is expected to establish separately an investigative commission on financial administrative system reform and to review the following points:

(1) Strengthen the independence of the People's Bank of China (PBC) as the central banking organization.

(2) Streamline the planning functions of diversified financial administrative systems.

(3) Respond to future prospect of the current regulation which prevent a financial institution from running banking, securities and insurance, the current financial regulatory system with three separate sectors departments should be reviewed and, if deemed necessary, the three regulatory commissions should be integrated.

(4) Analyse the cost and benefit of the policy options integrating or separating the planning and regulatory functions of financial administration.

The above process should not only respond to advances in financial deregulation, and enable finance to fulfill its function as the "lifeblood" of the economy, but should also allow it to serve as a "generator" of economic activity.

19. Strategic Action Plans

Strategy 1: Reform institutional finance

Action plan 1: Reform the policy-based lending system

Background

(1) The necessity of responding to the shift of the situation of Chinese economy and development of the western region

Based on its 11th Five-Year plan, China envisages the new dimension of its strategy on economic development. In the western region, the focus will shift to the issues such as compulsory education, local industrial development, agricultural / rural development, and better living environment.

(2) Review of policy-based lending system reform

Chinese government is currently reviewing the institutional arrangement with three policy-based banks and the reform of the policy-based financial system.

Recommendation

The theoretical background behind the institutional design and framework for policy-based financial system reform are presented in the form of an action plan hereunder as below.

(1) Institutional design corresponding to development level

The optimal mechanisms for policy-based finance should be devised according to national conditions, the stages of economic and financial development, and the fiscal healthiness of China. In China, there are persistent needs for government intervention in specific sectors of the economic system through the policy-based lending. Depending on the level of economic and financial development, the areas of current policy-based lending should be examined whether to be reinforce or to be reduced or abolished.

(2) Principles and roles of policy-based lending

In accordance with two principles for the deployment, namely, 1) public interest and 2) the difficulty in assessing financial risk of commercial finance, policy-based lending should serve as a supplement, in both qualitative and quantitative terms, to commercial finance. In other words, policy-based lending should be limited to those sectors wherein an irrefutable necessity for the usage and the difficulty of performing risk assessments have rendered it impossible to provide credit in an appropriate form.

(3) Dividing policy-based lending

To avoid policy-based lending being mired by the twin failures of market and government, the current policy-based lending system must be divided on the basis of 1) public interest and 2) difficulty of performing financial risk assessments. To this end, policy-based finance should be reorganized into the following three categories on the basis of the degree of grant element and marketability: 1) more concessional "institutional finance", 2) regular "generic policy-based lending", and 3) "switched to commercial finance" in line with commercialisation.

1) Switching to commercial finance

Among the sectors in which policy-based lending has once played a major funding role, competition between policy-based finance and commercial finance can be observed as the industrial sector matured. Examples include the power sector, expressways, arterial railroads, the petrochemical industry, urban infrastructure and telecommunications. For those sectors in which policy-based lending and commercial finance are competing, efforts should be made to affect a switch to commercial financing.

2) "Institutional finance" sector

On the other hand, policy-based lending systems have not been developed for those sectors that will serve as the foundation for the creation of a "fully affluent society", i.e. one that addresses poverty reduction, regional disparities, environmental conservation and the "three rural issues".

Handling such sectors using the policy measures such as policy-based finance is an urgent priority for China today. Accordingly, a highly-concessionary (grant element) policy-based finance system should be introduced for those sectors with a direct link to security in health and well-being, stability of livelihood, and improvements to standards of living, etc. It is proposed that this system should be institutionalized as bound to the concept of "institutional finance" within the framework of policy-based lending.

Institutional finance should be provided under statutory limitations, such as items to be qualified for funding, funding terms. Further, in case of provision of the separate policy-based lending using the different funding source and increased financial capital base, accounts of on-going and new lending should be separated rigidly. And at the same time, a framework for providing more concessional financing should be developed utilizing the new capital base.

Institutional finance lies halfway between financial grants and general policy-based lending. Outlays of fiscal resources for policy-based lending can be made on a considerably smaller scale than is required for financial grants. Even greater economic effects can be achieved as finance is utilized as a measure for the repayment of principal and interest and the credit creating function works.

3) The sectors to be covered by general policy-based lending
General policy-based lending covers the area between (1) and (2) above. In principle, the provision of this type of financing should be dependent upon bond issued by the various policy-based banks, and institutional design for such system should be undertaken.

(4) Policy-linked lending target sectors
In light of international trends, policy-based lending functions which China should focus on will be summarized as follows.

Regional development, infrastructure development, industrial projects:
In the coming years, policy-based lending will need to focus on the development of underdeveloped regions such as the western region, and on the facilitation of small- and medium-scale infrastructure. Meanwhile, corporate investment in pollution controls and energy-saving technologies will be the major force for the formation of a recycling society which also requires long-term, low-interest financing.

Small and medium-sized enterprises (SMEs)
In many countries, market mechanisms for SME financing often fail to function sufficiently, which justifies this sector to be supplemented with policy-based lending. In China, expansions will need to be made to both the credit guarantee system and to policy-based finance for SMEs.

Agriculture
In order to increase agricultural productivity and yield capacity whilst addressing the "three rural issues", institutional finance needs to be provided for agricultural production bases, the modernization of production techniques, and for comprehensive development of rural areas, all of which used to be bypassed by policy-based finance in the past.

Housing
The increased demand for private housing that has accompanied economic development means that China is at a stage where it must expand housing loan provision for low-income families.

Trade & foreign investment
In the area of trade and investment, the competition is often between international players. At the same time, the political risk is regarded as a significant factor influencing trade and investment to developing countries. Therefore, the necessity of official assistance for finance, guarantees, insurance and so forth is commonly understood internationally.

(5) Methods of institutional reform
There are four conceivable methods of institutional reform for the organizations responsible for providing policy-based lending.

1) KfW method
Providers of general policy-based leding and institutional finance are divided into parent and child organizations. Both are to be managed separately and self-sustainablly in line with differences in the nature and objectives of service provision, and to make effective use of human and informational resources.

2) The account-bracketing method
Both general policy-based lending and institutional finance accounts held at one organization are strictly separated, and an accounting firewall is set up between the two. In order to increase the efficiency of operations, furthermore, general affairs, management and research operations for both accounts are to be combined and administered together.

3) The fund method

For the loans that satisfy the certain conditions among the bank provided by the policy-based banks, a small-scale fund is set up outside the organization of the policy-based banks in order to provide special concessional funds as a limited measure.

4) The full independence method
In case that it proves difficult to ensure smooth flows of institutional funds using any of the methods described above, new institutional financial institutions with full independence from existing policy-based banks should be established.

Actual implementation procedures

(1) Step 1: A study by the financial system reform investigative commission
Prior to the official commencement of the work of an "investigative commission on financial systems", a working group on policy-based finance" should be established with the attendance of representatives from the relevant organizations requested. The working group should undertake a study on institutional reform with above-mentioned recommendation taken as the information necessary to conduct analysis..
After an investigative commission on financial systems is established, this working group should be transformed into its subordinate body. Outcomes from the study and the analysis should be submitted to the State Council in the form of a reform proposal after the review by the investigative commission on financial systems.

(2) Step 2: Development of a legal system
On the basis of the aforementioned reform proposal, the Basic Law on Policy-linked Financial Institutions (tentative name) should be enacted and related regulations developed.

(3) Step 3: Overall review of the reform progress
Once the aforementioned law has been enacted and the attendant regulations have entered into force, within the 5 to 10-year period, a general review of the policy-based financial system should be undertaken. The necessary institutional reforms should be implemented on the basis of review findings.

Points to be considered

(1) Preventing bloating
In order to avoid policy-based lending from becoming bloated, a cap should be imposed: e.g. the proportion of outstanding policy-based loans to GDP, etc.

(2) Optimizing financial tools
For those sectors in which need for policy-based lending has decreased in the course of economic and financial sector development, the types of lending should be shifted gradually to commercial finance. At the same time, for those ordinary budget items that fulfill necessary conditions, the financial measures should be gradually shifted to policy-based lending. Further, while financial measures are to be innovated, the shift to indirect loans, debt guarantee and co-financing should be promoted.

(3) Evaluations
Ex-ante and ex-post evaluations should be undertaken in respect of the operation of policy-based banks. The use of policy cost analysis should also be examined.

(4) Ensuring good governance
In order to ensure good governance of policy-based banks, attention should be paid to clarifying management responsibilities, to information disclosure, and to the development of internal management and auditing systems.

Action plan 2: Set up policy-based finance system to promote western development

Background

(1) The necessity for public assistance for economic and social development projects in underdeveloped areas of the western region
The financial profitability of economic and social development projects undertaken in the western region is often low. Commercial banks, which focus on profits, will not extend loans for projects that have major economic and social benefits but poor profitability.

(2) The necessity for raising the efficiency of public services
Projects that serve for the public interest but low profitability are, in many instances, implemented using government funds. However, there are various problems inherent in government-funded implementation, such as the existence of limitations stemming from government bond issuance and the fact that economic efficiency is frequently disregarded.

(3) The need for institutional finance
In order to enhance the profitability of economic and social projects undertaken in underdeveloped areas, the policy options should be considered to support them through provision of capital and subsidies. In terms of the financing methodology, the use of policy measures such as preferential interest rates, longer grace and repayment periods should also be examined.

Recommendations

Objectives
There are many areas where economic development lags behind the other areas with weak economic power in the western region. The fund provision for such areas, on the other hand, remains inadequate. In order to change these situations, the new "Western Development Fund（hereinafter the Fund; Development Fund for the Backward Area in the Western Region）" is to be established. The Fund provides financial assistance in the form of loans and guarantees for economic and social development projects for lesser-developed areas of the western region.

This proposal envisages a fund targeting underdeveloped areas in the western region, but a system establishing a fund that covers all the underdeveloped areas in entire China may also be a possible option. .

Related organizations
China Banking Regulatory Commission (CBRC), People's Bank of China (PBC), The State Council Office of the Leading Group for Western development of the National Development and Reform Committee (NDRC), Ministry of Finance, China Development Bank

Institutional status
For the following reasons, the establishment of the Fund as an independent fund is considered advantageous.

1) The establishment of the Fund can cause duplication with existing financial institutions such as the China Development Bank. Moreover, the knowledge and expertise of the China Development Bank may not be fully utilized.

2) In case of establishing the Fund as an independent financial institutions through the integration or separation of some branches of China Development Bank, the China Development Bank may face the structural contradiction in which it would not cover the western region.

3) Collaboration and coordination can be easily induced between the China Development Bank if the Fund is established as a subsidiary of the China Development Bank although it may risk the independence of the Fund.

4) In case of setting up a special account for the Fund within the China Development Bank, it may be difficult to ensure the independency between loan screening and accounting operations.

5) Setting the Fund up as a separate entity would have several merits: the systems and experience of the

China Development Bank could be utilized; setup and operation costs could be minimized; and the independence of loan screening procedures would be ensured.

Business description
The Fund will provide 4 types of financial services; loans, interest subsidies, guarantees and capital contributions.

Project formulation and initial examination will be undertaken by the China Development Bank, and then the selected applications will be submitted to the Fund. The Fund will make the final decision by further examination. Loan terms would be concessional, i.e. lower rates of interest than commercial banks and long-term repayment periods, etc.

Implementation structure
The Fund would be positioned as a financial institution under China Banking Regulatory Commission (CBRC)'s supervision. A steering committee would be established, which would be given the responsibility for the operation of the Fund. Steering committee members may include the director of the Fund and representatives from the China Development Bank, the State Council Office of the Leading Group for Western development etc.

Funding targets
The main financing targets are projects that fail to meet the lending criteria of the China Development Bank or commercial banks by its profitability and financial risks however with high public interest and/or external economy. Since these projects are less profitable despite its high public interest profile, may not be financed by either the China Development Bank or commercial banks.
The focus would be on regional infrastructure development, environmental conservation and poverty reduction, while agricultural promotion projects would be also considered to a limited extent.

Envisaged fund size
Approximately RMB 20-30 billion is considered as an appropriate level for the initial capital of the Fund. This amount would be gradually increased after the Fund is set up. The initial sum equates to less than 10 percent of outstanding loans to the western region of the China Development Bank, or one-third of annual loan increases.

Capital source
The Ministry of Finance (central government) would contribute the necessary capital. In allocating resources to the Fund, central government subsidies to the regions, government bond investment funds and so forth should be reviewed and set in order and central government treasury funds cleaned up and consolidated so as to secure the necessary funds. In the event that this process proves time-consuming, procuring funds via the issuance of government bonds etc should also be investigated. The use of the China (Central) SAFE Investments Limited fund and/or foreign capital should also be explored.

Transferring the central government funds that are currently being provided by free of charge to the western region to secure the operating capital of the new Fund should also be considered.

Transferring government funds that have been dispersed in the form of fund transfers and subsidies to the Fund can be expected to (1) enable objective evaluation of the feasibility of western development projects via the loan screening process to be implemented by the Fund, (2) enable funds to be utilized effectively since the investment fund will be repaid by profits generated from the project, and (3) increase credit creation effect via financing process.

Implementation procedures

(1) Examination of business descriptions and setup modes for the Western Development Fund
The aforementioned "working group on policy-based finance systems" or a specially-inaugurated "working team on the Western Development Fund" that would be subordinate to the working group, should undertake a study on 1) the pros and cons of establishing the Fund, and 2) the various conditions that will need to be made in the setup process, and 3) the creation of a blueprint of the Fund.
Representatives from the China Banking Regulatory Commission (CBRC), the People's Bank of China (PBC), the State Council Office of the Leading Group for Western development, the Ministry of Finance

and the China Development Bank are expected to the member of the working group.

(2) Budgetary measures
Secure the necessary treasury funds to establish the Fund.

(3) Approval procedures for the Fund
Formulate plans for the establishment of the Fund and submit to the State Council for deliberation.

(4) Preparations for the establishment of the Fund
Set up the Fund steering committee, which will then take on the bulk of the preparation work to be made in advance of fund establishment.

Points to be considered

(1) Securing consistency with national policy on western development
The Fund needs to be consistent with the national policy on western development which should also be in line with the actual needs of underdeveloped areas.

(2) Formation of policy-making / evaluation guidelines for western development
"Policy-making / evaluation guidelines on western development" should be formulated in respect of institutional finance provision to western China. These guidelines should contain criteria for determining eligibility for institutional finance, i.e. the terms that need to be met. It will also be necessary to create a system to ensure sound pre-screening, monitoring and ex-post evaluation of projects funded or capitalized by the Fund.

(3) Tie-ups with the China Development Bank, etc.
The China Development Bank is envisaged as the implementing organization for the Western Development Fund. Making maximum use of the Bank's regional branch network, its information on trusts and pool of financial officers, will ensure the Fund's efficient and rational operation.

Action plan 3: Develop institutional finance for agricultural development

Background

In order to resolve the "three rural issues" in the western region, the introduction of high value-added crops – fruit trees and vegetables, etcetera, and livestock expansions will be critical to raise cash income to farmers. Land reclamation projects and construction of irrigation and water conservation facilities need to be executed in potential areas, in order to increase unit yields, promote crop diversification and clear the path for income increases.

Such farm conversions and infrastructure development projects generally require initial investment that exceeds the self-funding capabilities of farmers, and also return-on-investment occurs in the mid- to long-term. In view of the protracted nature of repayment periods and the risks involved, commercial banks will have almost nothing to do with the funding of such projects. Nor are such projects eligible to receive funding from the Agricultural Development Bank of China, a policy-based bank, meaning that insufficient fund provision is available.

Recommendations

Promote trial-based provision of a new type of priority, policy-based funding to the western region's highly backward agricultural sector.

(1) Types of funds envisaged
The main types of funding envisaged are policy-based funds targeting the agricultural sector, as described below.

1) Out-of-pocket expenses (farmer) on medium-scale general development and/or infrastructure development projects (in the agriculture sector)
This would target predominantly county-level irrigation projects, watershed management projects and

land reclamation projects, i.e. projects other than those large-scale undertakings being promoted at either the national or the provincial level. Of these projects, regional government funds would be allocated to sectors with a high public interest profile (head works on irrigation facilities, primary / secondary irrigation channels, forests to protect water and soil, check dams, farm roads, etc). Farmers will be requested to fund those aspects destined for on-farm usage (terminal channels, the construction of rice terraces and orchards, planting of timber forest, etc), but in view of the fact that profits will be a long time coming and that stakes are large as compared to expected cash flows, loans will need to be long term (6-15 years) and low interest, and in certain instances, to have a period of deferment.

2) Capacity investment loans for modernization and/or commercialization ("farm modernization funds")
These would cover greenhouses, modern cattle stalls, prime quality cattle for dairy farming, tractors and other types of farm machinery, etc. The loans could also be used to develop related projects such as post-harvest equipment and seedling cultivation facilities. Such projects are an essential part of the modernization and commercialization of agriculture, but initial investment requirements exceed farmers self-funding capabilities and return-on-investment is expected to take between three to five years, at minimum. Since this constitutes investment in equipment, i.e. private assets, and some of the projects would be eligible for commercial financing, institutional finance should be limited to indirect loans and debt guarantees, etc.

(2) Responsible organizations
Besides direct loans from the Agricultural Development Bank of China, such funding could be provided by other commercial financial institutions and Rural Credit Cooperatives receiving agency loans from the ADBC. Given that such loans would be long-term, low-interest concessional loans, a separate institutional finance account for agriculture should be set up to be managed by the Agricultural Development Bank of China, with public investment into the account to be made as required.

Specific implementation procedures

The "working group on agricultural finance" of the "investigative study commission on financial system reform" that are proposed as part of the general reforms of policy-based finance should take the lead in undertaking the following activities.

(1) Comprehensive agricultural development / agrarian infrastructure development fund

Step 1: Create a detailed fund design
Categorize projects and/or farms considered to require institutional funding, compile a specific funding menu and decide on loan terms. Investigate other methods of fund use, including indirect loans, debt guarantees, and so forth.

Step 2: Decide on the fund-supply mechanism
Specify which organizations are to be responsible for providing the various funds (regional government organizations, commercial banks, agribusiness companies) and clarify their respective roles. Local governments are to provide information on financial assistance plans and intended scope and on risk assessments (the extent of technology penetration, the extent to which producers have been organized, infrastructure development status, the presence / absence of markets, etc).

Step 3: Implementation
During the course of this work, funds are to be extended to those farms already targeted under local government plans.

(2) Modernization fund

1) **In the short-term**
<u>Set up a venue for communication with financial institutions</u>
Solicit the understanding and cooperation of commercial banks with respect to the "modernization fund", and hold regular study sessions with financial institution representatives as a means of amassing the information that will form the basis for creating a concrete fund design.

Specify what assistance is to be provided from the agriculture policy fund
Based on the information obtained via the method detailed above, decide on a specific method of extending assistance using policy-based finance.

Develop funding guidelines
The aim of funding guidelines should be to provide a general reference guide to the scale of investment required for the respective target projects, profitability and risk factors, credit screening criteria for target farms, and cash flow analysis methods, etc.

Set the criteria for a farm recognition system
Objective data to be used in screening the farms that are being targeted for funding should help to reduce the screening operations and investment costs of financial institutions. From this standpoint, standards of recognition should be established towards introduction of a recognition system that is designed to separate out farms that are considered to possess the necessary technologies to undertake specific farming operations as well as sound management capabilities.

2) **In the medium-term**
Based on the above, work on commercial financial institutions to promote the provision of funds.

Points to be considered

Explore the possibility of incorporating the agricultural policy fund into the overall Western Development Fund framework.

In the mid- to long-term, the establishment and/or strengthening of institutional financial institutions with a specific mandate to handle "agricultural policy funds" for target projects, such as those cited above, is recommended.

It should be born in mind that trial implementation in the western region will contribute to the development of institutional finance in the agricultural sector, an issue that will need to be dealt with at the national level in the future.

Strategy 2: Reform rural finance

Action plan 4: Reinforce the reform process of Rural Credit Cooperative

Background

To date, reform of rural credit cooperatives has focused on organizational restructuring and management shakeups. Henceforth, the focus will be on improving service quality and raising the level of customer satisfaction, with a view to enhancing the business operations of the rural credit cooperatives. With virtually no competition in the rural financing market in the western region the rural credit cooperatives have little incentive to voluntarily bring the quality of their services in line with regional needs.

Recommendations

So as to enable the rural credit cooperatives to evolve into community-based service providers, efforts must be made to improve and strengthen their business operations.

(1) Cultivate a customer-oriented culture
Managers (or teams) should be appointed at each of the credit cooperatives to develop credit cooperative strategy. Further, all employees should familiarize themselves with the strategies and broadcast this information to citizens in the local community.

(2) Surveying and analyzing financial service needs
Surveys of trends in the agricultural and rural sectors and of customers should be undertaken.

(3) Information transmission and network support
The rural credit cooperatives should be positioned as centers of information on agricultural and rural businesses (community) businesses in the region, and should bolster their function as mediators and/or

transmitters of information and business, including information on the market, on climate and on new policy relating to the agricultural sector, etc.

(4) Development of new businesses and acquisition of new customers
Financial services should be diversified to include money transfers, remittance, leasing of farm machinery and other equipment / facilities, and insurance, etc.

(5) Strengthen management
External experts on financial operations and business management should be requested to oversee the business operations of the credit cooperatives, and efforts made to enhance credit cooperative human resources by providing training on financial service provision and so forth.

(6) Promote business links between credit cooperatives
Business links between county (district) level rural credit cooperatives (or rural cooperative banks) should be promoted. Initial efforts could include the setting up of an ATM network and information sharing on customer credit, etc.

(7) Introduction of a rural credit cooperative auditor certification system
A system for "certifying agricultural finance auditors" should be established to highlight areas requiring improvement such as the auditing of rural trust banks and rural credit cooperatives, account processing, credit screening, fund management, and internal risk management, and to provide guidance on affecting such improvements.

Specific implementation procedures

Step 1: Draw up a mid-term business strategy
A three-year, mid-term business strategy should be developed for county (district) level rural credit cooperatives (or rural cooperative banks). Simultaneously, human resource development plans should be drafted so as to render the strategy achievable.

Step 2: Implementation and monitoring of the business strategy
Each of the credit cooperatives should monitor the implementation of the business strategy and submit annual reports at the general meeting of members.

Points to be considered

Companies affiliated to the provincial government could be requested to provide the necessary secondary support, whilst respecting the independence of each Rural Credit Cooperative (Rural Cooperative Bank). Such companies could play a major role by providing guidance and suggestions on business management, promoting experience and expertise sharing, and petitioning the government vis-à-vis the advantages of credit cooperatives.

Action plan 5: Pilot the credit financing through the Agricultural Producers' Association

Background

There is much potential for developing a cooperative-based credit business in the economically backward western region. By utilizing cooperatives, it should be possible to resolve the problems inherent to agricultural financing, namely, high transaction costs and complex collateral settings, by providing credit based on the reciprocal links between cooperative members. However, the western region has few full-time cooperatives with strong organizational skills or business management skills. To enable the cooperatives to provide new credit services sustainably, capacity-development will be needed for organization and business operation and management.

Recommendations

A pilot scheme involving the provision of credit services by full-time cooperatives should be implemented in the western region and the systems and support mechanism needed to contribute to the development of such cooperatives be established based on the results of the pilot scheme.

In specific terms work should be undertaken to: (1) promote financial institution financing of cooperative members by strengthening the credit guarantee function of full-time cooperatives, and (2) to provide financing to cooperative members of funds procured by the organization (i.e. the cooperatives) from financial institutions, based on independent criteria and terms.

Specific implementation procedures

The pilot scheme should extend for a maximum of three years.

(1) Step 1: Set up task forces
Task forces comprising members from the separate bank of People's Bank of China (PBC), the Ministry of Agriculture, the Banking Regulatory Commission, and other relevant organizations, should be established in each of the provinces. County government employees are to be responsible for providing direct assistance to the collaborative organizations. The main role of the task forces will be to promote independent activity by the collaborative organizations, to monitor such activity, and to provide secondary support.

(2) Step 2: Select target collaborative organizations
These should be picked from among the Agricultural Producers' Associations in the western region. The selection of three organizations each from the two provinces in the northwest and the two provinces in the southwest, i.e. twelve in total, should be sufficient. As key selection criteria, the collaborative organizations should be able to demonstrate their willingness to provide credit services, should have been established for a certain number of years, should be running their organization democratically, and should be proactive in the undertaking of cooperative activities.

(3) Step 3: Develop rules of administration and business plans
Each of the collaborative organizations should develop rules of administration for its credit business and draw up business plans. The rules should be drawn up by a democratic process, and emphasis should be on the independence of the collaborative organizations. The following support should be extended to this process.

1) Capacity-development support for organization-building and credit business operation
The county representatives should form links with the Ministry of Agriculture, civilian experts and so forth and extend due support to collaborative organizations members in the process of developing credit business operation regulations. Guidance relating to the credit business, i.e. credit assessments and funding terms (duration, interest rates), should be outsourced to the rural credit cooperatives or rural credit banks.

2) Financial support
The funds needed by the collaborative organizations for furniture/fixture purchases and internal information transmissions should be partially subsidized.

(4) Step 4: Review sessions and pooling of experience
Once a year, representatives from the target collaborative organizations in each of the provinces and members of the task forces should be brought together for a review meeting. At the meetings, progress reports should be presented and problems that have emerged in the course of providing credit services as well as the need for additional capacity-development should be discussed.

Each of the provincial task forces should compile reports, either annually or at the end of the pilot program, and make proposals regarding the potential for developing the cooperative credit business. The relevant central government ministries should study the reports and proposals and should promote separate research and, based on their findings, draft plans for institutionalizing cooperative financing in the rural sector and develop the necessary support systems.

Points to be considered

Subsidiary organs of the Provincial Banking Regulatory Commission could undertake audits and provide guidance on a regular basis.

Action plan 6: Strengthen microfinance in rural areas

Background

The development of microfinance as a tool for poverty alleviation has been more and more recognized as a priority political issue. However, hardly any microfinance institutions have been able to make sufficient profits to expand their businesses.

Recommendations

A sustainable system to help microfinance to reach the poor is to be developed by expanding roles of the microfinance (MF) institutions, namely rural credit cooperatives and private MF institutions, and by improving their operations and support systems.

(1) Institutional reform
Private MF institutions are encourage to be developed in order to absorb the unsatisfied demand of the poor for the microfinance, which is not being fully covered by official financial institutions, namely by the rural credit cooperatives.

The private MF institutions should be authorized of the lending and the commission to place deposits with financial institutions. In addition, the revolving fund from the poverty alleviation fund should be further utilized to provide services to the absolute poor, which is beyond the reach of the credit from the financial institutions and the private MF institutions. In order to make the limited fund available to as many people as possible, the revolving fund should be permitted to be used as loans with some charges for the administrations fees, which replace the interests.
(2) Operational improvements

1) Review interest rates
Microfinance institutions should be encouraged to set their own interest rates after due efforts are made to analyze and cut costs, which are divided into fund-raising, operation, and credit risk.

2) Review repayment terms
Repayment periods for the microcredit should be varied including those longer than one year. An installment repayment should be applied for loans to the poor.

3) Standardize and disclose account management procedures
Microfinance institutions should be obliged to standardize and disclose the accounting in accordance with the guidelines compiled by the CGAP (Consulting Group to Assist the Poor).

4) Encourage the introduction of information technology (IT)
Introduction of Management Information Systems (MIS) is necessary to control and manage loans with different terms properly.

5) Review center meeting functions
The information exchange function of the center meetings should be utilized by the rural credit cooperatives in providing group-guarantee credits to the poor.

(3) Support for microfinance institutions

1) Strengthen linkages between technical assistance providers
Establish a system that enables the relevant departments of county and township governments to extend the necessary technical assistance to farmers. Based on information provided by microfinance institutions, the local government units should formulate technical assistance plans and implement the necessary training.

2) Stable provision of funds
The government should assist the microfinance institutions in standardizing their accounts and introducing IT; thereby promoting fund contributions from the donors.

3) Exemption from business tax
Microfinance institutions should be exempted from payment for the business tax.

4) Institutionalization of the microfinance network
The microfinance network which was established with the memberships of the leading private MF institutions should be authorized as a microfinance association, and its activities including training, technical assistance, and information exchange should be promoted.

Specific implementation procedures

(1) Pilot projects on the private MF institutions
The Banking Regulatory Commission and the People's Bank of China should try out the aforementioned recommendations for the operational improvements in the planned pilot projects on the private MF institutions in Guizhou, Sichuan, Shanxi and Shaanxi. Based on the results, recommendations should be compiled for implementations including those for the rural credit cooperatives.

(2) Issuance of a statement from the State Council
The State Council issues a statement based on the recommendations compiled from the result of pilot projects described (1) above. As detailed hereunder, the statement should clarify the roles to be played by the various organizations for promoting microfinance.

(3) Notification of operating procedures by the Banking Regulatory Commission
Based on the aforementioned statement, the Banking Regulatory Commission should notify microfinance institutions of operational procedures. Given the diversity of the private MF institutions, the procedures for the private MF institutions should be kept to a minimum in order to respect their independencies.
(4) Reviewing the funding for the microfinance institutions by the People's Bank of China
In order that the microfinance institutions able to receive a steady flow of funds, the People's Bank of China should study into the followings: 1) possibilities to provide "refinancing loan for pro-agricultural undertakings" over one year, 2) adjusting the lending volume of "refinancing loans for pro-agricultural undertakings" based on the operational performance of the rural credit cooperatives, and 3) possibilities for the private MF institutions to receive loans from the financial institutions.

(5) Study on business tax exemptions by the Ministry of Finance
In order to lower the interest rates on microcredit, the Ministry of Finance should undertake a study into exempting microfinance institutions from the business taxes incurred on microfinance transactions.

Points to be considered

Strategy 3: Foster regional banks

Action plan 7: Foster financial institutions and expand financial sector that serve for the community needs

Background

(1) The need to build community-based financial institutions

(2) The importance of improving the financial services provided by city commercial banks

(3) The importance of legalizing non-banks in improving financial service quality

(4) The importance of circulating postal savings funds within the region

Recommendations

Objectives
The aim should be to 1) provide financial services that are close to the community and consistent with local needs, and 2) create a system that enables funds to circulate within the region by diversifying the range of financial institutions operating in the region and expanding financial service provision

To this end, 1) development of community-based financial institutions, 2) legalization and development of non-banks and 3) utilization of postal savings within the region should be promoted. This will contribute to activation of the local economy by increasing and diversifying funding channels within the region and increasing efficiency of fund allocation throughout the overall economy.

Related organizations
China Banking Regulatory Commission (CBRC), People's Bank of China (PBC), State Post Bureau of China and the China Banking Association (CBA)

(1) Development of community-based financial institutions
Local-based financial services of city commercial banks towards regional economy, SMEs and private customers should be strengthened to enhance their function as regional banks. In specific terms, emphasis should be placed on: 1) maintaining long-term and good business connections with clients, 2) expanding the range of services available, and 3) reinforcing local industry support functions.

(2) Legalization and development of non-banks
In China, private financing (non-bank financing) has a significant weighting in the fund-raising activities of SMEs and farmers. Privately-operated businesses are growing in Wenzhou, for example, and private financing plays a key role in fund-raising within the area. The People's Bank of China (PBC) is in the process of legalizing non-banks on a trial basis.

If non-banks were to be legalized they would come under government jurisdiction and it would thus be possible to impose certain limits on their lending activities: i.e. on their business operations, loan terms, debt collection activities, and so forth. Giving non-banks an operational mandate would also make it possible to ascertain the status of their finances. Non-banks would gain from their new legal status in that their enhanced creditworthiness would bring in more customers and increase the number of channels via which to procure funds and etc.

(3) Develop postal savings banks as community-based financial institutions and circulate postal savings within the region
Postal savings banks have a network of branches that extends the length and breadth of China. Utilizing this network would facilitate the development of community-based financial services. This can be expected to expand the range of financial services available to local communities at postal savings banks, which would function as community-based financial institutions.

Diversifying the operation of idle postal savings and developing mechanisms to circulate them throughout the region should also be investigated. In terms of the orientation of operational diversification: 1) the granting of operational autonomy to certain branches within the region, 2) the outsourcing of loans and fund operations to other financial institutions in the region, 3) co-financing of regional development projects, and 4) the establishment of an investment fund for specific regions (e.g. a western region investment fund), are conceivable options.

Specific implementation procedures

(1) Expand and improve community-based financial services

Step 1: Study business models for community-based financial institutions
The China Banking Regulatory Commission (CBRC) and China Banking Association (CBA) should lead an investigation into business models for community-based financial institutions. Data should be gathered on successful initiatives being undertaken by the various banks to improve their financial services to be used as reference for the aforementioned study.

Step 2: Broadcast the vision for community-based financial institutions
Meanwhile, the financial institutions should put together a package of measures designed to expand community-based financial service provision, and publish this as their vision for community-based financial institutions.

Step 3: Extend support to the initiatives being undertaken by individual financial institutions
Support should be extended to regional financial institutions in the undertaking of the aforementioned initiative. The local branch of the China Banking Regulatory Commission (CBRC), local governments and

the local business community should extend their cooperation and support.

The following is a list of tasks that could be undertaken by regional financial institutions as part of efforts to expand community-based financial service provision:

1) Strengthening of loan screening capabilities (close communication with customers, the creation of a credit information database, IT-based loan screening, the development of a loan screening manual, improvements to industry-specific loan screening, etc.)
2) Increasing the efficiency of loan screening and account management
3) Strengthening of post-financing management
4) Organizational reform to facilitate community-based financial service provision
5) Expansion of the consulting services available to customers
6) Strengthening of financial planning functions
7) Utilization of external personnel
8) Strengthening of human resource development
9) Propagation of best practice, etc

(2) Legalize and develop non-banks

Step 1: Investigate the optimal system for legalizing non-banks
The China Banking Regulatory Commission (CBRC) and the People's Bank of China (PBC) should lead an investigation into the type of non-banks that should be legalized. The terms for accreditation and registration of non-banks should also be studied.

Plausible terms include business category, fund size, clientele, funding sources, business area, the career histories of managers, past sales records, etc. A study into the measures needed to ensure sound management of non-banks should be undertaken simultaneously.

Step 2: Establish a provisional law on non-bank regulation
A study should be conducted on the scope of non-bank regulatory activities to be undertaken by the financial authorities. Once responsible financial authorities, registration procedures, reporting obligations, loan screening, user protection, transactions requiring regulation, and penalties for illegal activity have been investigated, a provisional law on non-bank regulation should be drafted and enacted.

Step 3: Implement a non-bank model project
Non-banks within a restricted area should be accredited on a trial basis and a model project undertaken.

Step 4: Develop a law on non-bank regulation and amend related legislation
Based on the results of the aforementioned model project, a law on non-bank regulation should be enacted. The necessary amendments to related legislature should also be made.

Step 5: Diversify non-bank fund procurement
Based on the circumstances, a study should be undertaken into whether non-banks are to be permitted to source funds from financial institutions and/or financial markets. If such fund-raising activity is to be permitted, revisions should be made to the relevant legislature.

(3) Utilize postal savings funds within the region

Step 1: Develop plans for the establishment of postal savings banks
In developing plans for the establishment of postal savings banks, a study should be made on the content of financial services to be provided by such institutions. This study should cover personal loans, personal settlement services, and sales of financial products, etc. The financial expertise needed to provide these financial services, management systems, computer systems, network systems and human resource development requirements should also be clarified. Looking to the future, an investigation into business loans and the co-financing of government projects should also be undertaken.

In view of the fact that current financing capabilities are insufficient, postal savings banks could start out by providing savings-guaranteed loans, small loans for limited purposes, secured housing loans and so forth. As financial expertise is accumulated, so the banks should plan the gradual diversification of their financing business.

Step 2: Investigate operational diversification of postal savings
An investigation into diversifying the operation of idle postal savings should be undertaken. This study focuses on operational methods from the perspective of expanding the circulation of postal savings. In view of the macro-finance policy of the People's Bank of China (PBC), a study on the optimal method of operating postal savings will also need to be undertaken.

Step 3: Development of related legislation
The legal structure needed to diversify the operation of idle postal savings detailed above will need to be established.

Step 4: Acquire knowledge of fund operation and risk management
Knowledge of the operational techniques that will become necessary in line with the aforementioned diversification of idle postal savings operation should be acquired and appropriate risk management systems installed.

Step 5: Monitor postal savings operation
The above process will result in the extension of postal savings operations and fund management status should be subject to continuous monitoring.

Points to be considered

Strategy 4: Diversify project financing

Action plan 8: Issue local government bonds

Background

Regional government finances are currently in a chronic state of deficit. By contrast, there are substantial needs for social welfare funding on infrastructure development, education and healthcare, for example. Given the circumstances, a lifting of the ban on government bond issues is currently under debate as a new means of procuring funds for local government.

Any issuance of local government bonds should be made conditional on the independence, soundness and transparency of the local government unit's finances.

Recommendations

Objectives
To review the fiscal system of local governments and increase the fund-raising options open to such government units through local government bond issues.

The following three steps should be taken towards realizing the Objectives of local government bond issuance:
Step 1: Undertake a study into local government bond issuance
Step 2: Establish terms for local government bond issuance
Step 3: Issue local government bonds

Related organizations
Ministry of Finance, China Securities Regulatory Commission (CSRC)

Specific implementation procedures

(1) Step 1: Undertake a study into local government bond issuance
A study on local government finance reform and the issuance of local government bonds should be undertaken and consensus established within the government as to the policy measures to be taken.

(2) Step 2: Establish terms for local government bond issuance
This is postulated on the establishment of an autonomous fiscal framework within local government.
Via the implementation of the measures described hereunder, the fiscal revenue and expenditure of local governments should be balanced and an autonomous fiscal framework established.

1) Obtain an accurate picture of the state of local government finances (survey local government debt to ascertain the existence of any hidden liabilities; introduce systems for assessing and ranking local governments)

2) Take structural reforms of local government a step further (reduce personnel spending by downsizing local governments; promote greater administrative efficiency; separate local governments from profitable business undertakings; outsource administrative services; improve those administrative services being provided by local governments; introduce a system for assessing structural reform of local government units based on the administrative review system)

3) Promote reviews of central and local government fiscal administration; improve the revenue and expenditure structure of local government units (review budgetary systems; review system employed for allocating tax revenues to central / local government units; introduce a central government system for monitoring local government finances; review the current system of issuing treasury bonds by proxy; secure funds for the provision of basic social services, including education and healthcare; review the budget law; set forth regulations on the handling of the bankruptcy of local government finances)

4) Establish a system of local government finance governance (achieve local government finance transparency; create balance sheets; itemize unlisted liabilities; enforce disclosure; establish sound financial codes and morals; introduce external fiscal check mechanisms)

(3) Step 3: Issue local government bonds
The lifting of the ban on local government bonds should be implemented in stages and on a trial basis, the removal being expanded gradually with an eye to conditions on the ground.

The lifting of the ban on local government bonds could be undertaken according to the following process:
1) The organization responsible for implementing projects involving local government units issues revenue bonds under local government guarantee
2) Bonds are issued under guarantee from a dedicated insurance company co-founded by the central government, local governments and financial institutions
3) Local governments issue un-guaranteed bonds

Local government units that satisfy certain conditions: i.e. have a sound fiscal balance, high-level administrative capabilities, and development needs in the form of urban infrastructure development, could then be accredited gradually and on a trial basis.

Points to be considered

Action plan 9: Establish regional financial centers in the western region

Background

(1) The necessity of expanding capital markets in the western region

(2) The necessity of funding venture companies in the western region

Recommendations

Objectives

Using the measures detailed below to cultivate regional loan centers in the western region, aim to expand capital markets and to diversify and increase the number of funding channels available to those with funding requirements in the western region.

Main aspects of the proposal:

(1) Expand the function of regional loan centers operating in large-scale, core cities in the western region
(2) Increase the number of funding channels available to venture companies operating in the western region
(3) Enlarge investment funds for western development
(4) Establish a securities market in the western region

Related organizations

China Securities Regulatory Commission (CSRC), China Banking Regulatory Commission (CBRC), local government units, Ministry of Science and Technology, Ministry of Finance

Specific implementation procedures

(1) Encourage clustering of financing functions in large, hub cities in the western region

1) Improve the reliability of financial administration (maintain the consistency of financial policy; eliminate local government intervention in financial transactions; strengthen financial supervision and financial risk management systems; provide comprehensive investor protection)

2) Invite and develop financial institutions, including foreign banks, and finance-related service industry proponents to the western region (develop finance-related infrastructure: data networks and so forth, and provide inexpensive services; train and supply outstanding human resources; furnish financial industry proponents operating in the region with preferential measures, including tax breaks)

3) Make efforts to expand funding transactions (increase transactions in global bank bond markets; increase transactions in global bank call markets; promote corporate bond issuance and activate the underwriting business (identical to (2) below); establish multi-type investment funds (identical to (3) below); establish a regional securities exchange (identical to (4) below))

4) Other activities (expand the insurance market; expand securities exchange operations; cultivate local industries; encourage market listing of regional financial institutions; provide training in financing, including financial risk for households)

(2) Increase availability of venture capital for venture companies operating in the western region

1) Consolidate the business environment for private-sector businesses (expedite licensing procedures and promote further regulatory easing; tighten intellectual property rights protection; create business opportunities using industrial policy designed to cluster industries; create business opportunities through comprehensive development projects, e.g. urban development, etc)

2) Grow venture capital (encourage regional financial institutions and investors to create venture capital for local venture companies; investigate the application of preferential measures to venture capital in terms of the tax system; list the investment funds of venture investment companies on the securities exchange)

3) Support venture company creation (encourage cooperative ventures with universities and research institutions, etc. provide facilities at incubation centers; provide credit guarantees through credit guarantee institutions; provide consulting services to support venture company creation, etc)

(3) Expand investment funds in the western region

1) Diversify investment funds (expand venture investment funds; expand private placement funds; expand western region industry investment funds for investment in companies operating and/or projects being

undertaken in the western region)

2) Introduce and diversify asset securitization (advance research into methods of asset securitization and train "arrangers"; introduce and expand real estate investment trusts (REIT); introduce and expand collateralized loan obligations (CLO); diversify other forms of asset securitization)

(4) Establish a local securities exchange in the western region

1) Investigate the pros and cons of establishing a local securities exchange and select a base city

2) Create the detailed design for the establishment of a local securities exchange (formulate governing regulations for the local securities exchange; determine the standards and procedures for over-the-counter listing; design the over-the-counter market system; investigate terms and procedures for closure of the local securities exchange)

Points to be considered

Action plan 10: Full-scale facilitation of PPP (Public-Private Partnership)

Background

(1) Demand for massive investment in industrial infrastructure
It is estimated that investment of approximately RMB 2 trillion will be required between 2006 and 2015 for industrial infrastructure development in the western region (railways, roads, airports, west-to-east transportation links, west-to-east power transmission, water supply systems and power generation); of which the necessary investment in railroads is forecast to amount to approximately RMB 1.2 trillion.

(2) Difficulty of increasing fiscal injections
It will be difficult to cover projected demand for large-sum investments in industrial infrastructure over the next ten years with the current levels of fiscal injections from central government funds.

(3) Procurement of funds in proportion to progress in each infrastructure sector
Progress in industrial infrastructure development varies by sector, and there is a need to employ the most suitable fund-raising techniques for each sector.

Recommendations

Aim to introduce Public-Private Partnership (PPP) in accordance with the degree of market pre-eminence in each of the industrial infrastructure sectors.

(1) Full-scale deployment of PPP in those sectors capable of achieving self-sustaining profitability
The most appropriate PPP scheme should be selected and implemented on those projects with the potential to achieve commercially-based (or quasi commercially-based) self-sustaining profitability.

(2) Development of a system that will serve to diversify investors and funding sources
To achieve the full-scale deployment of PPP, every effort should be made to encourage the emergence of primary PPP contractors to undertake industrial infrastructure development projects. At the same time, the government should prepare a system that will make it easier for such contractors to procure project funds from the market.

(3) Development of human resources capable of utilizing the latest financial technologies, the legal structure and risk management systems
The development of banks capable of fully deploying advanced financial technologies such as project financing, asset securitization, swaps, options, risk financing and so forth, should be encouraged, and financial officers, the legal structure and risk management systems created.

(4) Introduction of the principles of competition and utilization of the overall development capabilities of the private sector

In the coming decade, markets should be opened up, new technologies and management techniques introduced into industrial infrastructure sectors via the introduction of competition. Consequently, international competitiveness should be strengthened and domestic and foreign private sectors should be utilized for development.

Specific implementation procedures

(1) Commercialization and corporatization (introduce income statements and balance sheets in those sectors in which organizational and managerial reforms are lagging, including municipal water supplies, gas, sewage disposal, and municipal roads, etc; also, make use of service contracts, management contracts and concession contracts, etc)

(2) Eliminate monopolies (intensify competitions among spun-off companies in the telecommunications, power, oil and natural gas sectors; introduce regional separation to the transport sector; use long-term concession contracts to consign water and sewerage and gas supplies to the private sector)

(3) Market listing and/or partial disposal of government-owned joint-stock corporations (list telecommunications, power, oil and gas companies on domestic and foreign stock markets; break up national railways and list the stock)

(4) Reform management practices via the introduction of private-sector management techniques (introduce business technologies and management techniques using the private capital that enters the sectors via partial disposal (of government-owned companies))

Points to be considered

(1) The necessity of long-term strategies

(2) The assurance of the openness and transparency of the bidding process

(3) The necessity of government commitment

Strategy 5: Reinforce strict financial risk management and renew finance related information, knowledge, and skills

Action plan 11: Develop a financial risk management system

(1) General improvements to facilitate risk management at financial institutions

Background

In the coming years, all financial institutions will need to adopt the latest techniques in risk management.

Moreover, the regulatory commission will need to effect ongoing and widespread improvements so as to enhance the efficacy of risk management within financial institutions.

Recommendations

(1) Technology transfer of advanced risk management techniques

(2) The development of accounting standards and regulations

(3) The promotion of disclosure

Specific implementation procedures

Proposals of (1) and (2) should be investigated and implemented immediately. The impact on financial systems will need to be taken into account when working on Proposal (3), proportionate to progress in development of a deposit insurance system.

Points to be considered

The development and implementation of Proposal (2) should be undertaken in the light of the prevalence of "off-balance sheet" transactions. Where necessary, this proposal should be applied to client companies as well as to financial institutions.

(2) Improvement and strengthening of financial inspections

Background

As financial system reform and financial deregulation progress, the need to monitor the inspections undertaken by the regulatory authorities will become increasingly pressing so as to facilitate the accurate diagnosis of real risks in financial institutions.

Auditing authorities will need to develop new methods of inspection in order to respond to the changing risks facing financial institutions. The effectiveness of risk audits will also need to be enhanced via the appropriate combination of regular and irregular, on-site and off-site, prior notice and unannounced audits. Given the importance of double checks on compliance at financial institutions, financial audits will need to be undertaken by a number of inspection agencies.

Recommendations

(1) Expansion of the auditing system (major increases in auditor numbers at each of the regulatory commissions; publication of financial auditing manuals)

(2) Establishment of several auditing agencies (financial audits by the People's Bank of China (PBC) in addition to the audits undertaken by existing regulatory commissions)

Specific implementation procedures

Proposals (1) and (2) should be investigated and implemented immediately.

Points to be considered

Increase of auditors will need to be undertaken systematically, and it is also important to secure high-quality personnel.
Work to promote PBC audits will need to be combined with the strengthening of PBC functions as the central banking organization.

(3) Utilization of capital adequacy ratio regulations

Background

It has been pointed out that the problem with capital adequacy ratio regulations that are based on risk-adjusted assets is that the uniformity of risk weightings, long- and short-term credit periods, credit concentration limits and collateral, etc, are not reflected in the risk weighting.

Errors made in the setting of credit risk weightings run the risk of having an adverse impact on the industrial development of a nation. Lowering the risk weighting on loans for western development projects is one potential means of attracting capital to the western region.

Recommendations

(1) Utilization of capital adequacy ratio regulations (apply the capital adequacy ratio regulations set forward in the Basel Capital Accord to all banks providing international financial services; set capital adequacy ratios and asset risk weightings as regulations for banks that provide domestic financial services only; review risk weightings and capital adequacy ratios in proportion to the state of China's economy)

(2) Set risk weightings on loans for western development projects (give precedence on loans for western development projects when setting risk weightings)

Specific implementation procedures

Proposal (1) has been implemented for banks providing international financial services. The content of regulations applying to financial institutions that provide only domestic financial services is currently under review.

Proposal (2) is being implemented in the context of the Western development Program as a medium-term measure.

Points to be considered

In using preferential risk weightings on loans for western development projects it will be essential to dispense with all other direct finance-related instructions, etc. The use of risk weight settings as social policy, policy for the poor, for example, is a conceivable option.

(4) Promoting loan securitization

Background

In order to increase the effectiveness of capital adequacy ratio regulation and to encourage diversity in the risk management techniques used by financial institutions, loan securitization needs to be introduced as part of institution-development initiatives aimed at countering the use of numerators and/or denominators in risk weighting calculations.

Recommendations

The development of a system that incorporates investor protection measures, disclosure, and asset protection measures, etc should be forwarded so as to promote loan securitization. The development of a secondary market for security trading should also be promoted.

Specific implementation procedures

Investigate and implement immediately.

(5) Creation of a deposit insurance system, etc.

Background

As financial deregulation progresses, the need for a safety net as an alternative to unlimited government liability in connection with the management of system risk has begun to emerge.

To prevent the bankruptcy or other failure of individual financial institutions putting the entire financial system at risk, there is a need to develop an industry-wide safety net and to establish a deposit insurance system at the government level. The establishment of a reciprocal fund support system for financial institutions is a move that could be taken ahead of the development of a deposit insurance system.

Recommendations

(1) Introduction of an inter-financing support fund in the western region (the fund would be headquartered in the western region and comprise deposit-taking financial institution members, would accept deposits amounting to a certain percentage of the outstanding deposit balance, and would lend funds to member financial institutions whose operations were disabled in consequence of payments made due to disaster, etc)

(2)Introduction of a deposit insurance system (initiate investigations into a system applying uniformly to all deposit-taking financial institutions throughout the country, the development of a combined system covering insurance claim payments and the provision of financial assistance to bankrupt financial institutions, an investor protection system for the securities industry and an insurance contractor protection system for the insurance industry)

Specific implementation procedures

Investigate and implement proposal (1) immediately.

The deposit insurance system described in proposal (2) should be investigated and implemented as a medium-term issue. The protection system for the securities and insurance industries should be investigated as an issue in the mid- to long-term.

Points to be considered

The establishment of a deposit insurance system signifies a major transition in financial system administration, which has, to date, been prefaced, naturally (implicitly) on unlimited government liability, and could rock trust in financial institutions and the financial system at a single blow. All investigations will need to be carried out with due attention paid to the financial climate.

The inter-financing support fund could be established to cover specific categories of financial institutions, e.g. credit cooperatives and commercial banks, nationwide.

Action plan 12: Develop industrial finance information center functions

Background

To encourage (the operation of) a flexible financial intermediary function that is based on market economy principles in the field of industrial financing, it is critical that financial institutions accumulate and utilize information on the credit status and on the management and finances of companies, i.e. those entities with funding requirements, effectively.

Recommendations

(1) Objectives
To establish and operate an "industrial finance data center" with the aim of setting up and operating a "database of corporate credit information" that will allow highly-reliable credit information on companies operating in the industrial sector to be accumulated and utilized widely and cohesively, with a view to strengthening the development and use of basic data designed to aid financial institutions in the management of loans and risks.

In the medium term, the objective is to activate industrial fund flows by converting the information from the corporate credit information database into a more versatile "corporate information database" and endeavoring to increase the number of users and the range of data available, and by promoting the formation and development of a wide range of industry-funding services.

(2) Responsible organizations
Financial institutions should collectively establish and operate zone-based industrial financing information centers as corporate credit information database-management companies in large hub cities in broad-based blocks in the western region.

These centers should be set up as independent companies on the basis of capital injections from local governments and from the financial institutions that comprise their membership, and should be run autonomously by levying charges on the registration and use of corporate credit information.

The China Development Bank, which serves a policy-based financing function in the industrial sector, and the Industrial and Commercial Bank of China and other state-owned commercial banks with long years of experience in the field of industrial financing, should lead the promotional efforts with national commercial banks and regional financial institutions participating as members.

Further, local governments and chambers of commerce and industry should cooperate in initiating capital injections in the early stages of setup.

(3) Information center functions
The industrial finance data centers should collect, accumulate and process credit information on businesses, i.e. details of financial transactions, bill settlements, and so forth, and supply this in the form of credit assessments of member financial institutions and/or as reference data for managing transactions once a loan agreement has been signed.

Users of financial institutions will be able to make more accurate credit assessments since they will have access not only to in-house credit information on corporations but also to a wide range of highly reliable credit-related information registered by third-party organizations.

By registering credit information with a third party and making highly reliable disclosures businesses will be able to strengthen their creditworthiness and secure advantageous loan terms.

Specific implementation procedures

Step 1: Undertake an in-depth study of responsible organizations

Step 2: Formulate the contents and operational policy for the corporate credit information database

Step 3: Establish and operate industry finance data centers in large cities in the western region

Step 4: Network the various industry finance data centers and increase efficiency

Step 5: Promote smooth provision of financial services to industry by processing corporate credit information and adding to data

Points to be considered

(1) Publicizing (information on) the significance of using industry finance data centers

(2) Providing rigorous protection of personal information and other corporate credit information requiring strict confidentiality

(3) Promoting the registration and use of information from various types of businesses, including SMEs

(4) Developing the institutional environment to enable smooth provision of financial services to industry

Action plan 13: Develop financial statistical data and utilize economic models

Background

The People's Bank of China (PBC) is responsible for formulating monetary policy, for controlling the macro economy, for the stability of financial markets and the financial situation, and for executing financial policy-related duties. Financial policy is formulated and implemented by PBC headquarters, but a survey of economic and financial trends is being carried out in the regions so that regional PBC branches can support these operations.

Broad-based economic activities and fund transfers that extend beyond provincial administrative boundaries are on the increase. In consequence, the long-established method of gathering information from regional branches, formulating financial policy at headquarters and then issuing policy instruction to the regions has left the PBC struggling to provide a prompt and flexible response.

Recommendations

Objectives
To enhance capabilities in the collection and analysis of regional financial statistics and data so as to facilitate the implementation of appropriate financial policy that will make it possible to ascertain funding requirements in the western region and to secure stable supplies of funds.

Related organizations
People's Bank of China (PBC)

Specific implementation procedures

(1) Refine regional financial statistics and data
In order to maintain a stable demand and supply of funds for western development, the system for verifying financial statistics and data in the region needs to be strengthened. Accurately comprehending funding supply and demand in the western region will make it possible to formulate appropriate financial policy.

Accordingly, compiling financial statistics for each region on a regular basis will be useful in formulating policies on western development in the first instance and, more broadly, development and financing policies that are based on specific regional characteristics. It will be necessary to collect information to complement existing statistical data and to refine data on fund flows; the need to acquire accurate information on fund transfers outside the region is particularly pressing.

(2) Improve economic models on funding for western development
In order that financial policy designed to contribute to regional development can be effectively implemented, short, medium- and long-term economic forecasts will need to be made and more accurate projections on the impact of changes in financial policy on regional economics formulated. The use of economic models will make it possible to measure the effects on the real economy of economic policies, including fiscal / tax policies, industrial policy, regional development policy and so forth.

In the coming years, it is hoped that by expanding the dynamic model within the framework of the general equilibrium model the process via which the short-term impact of economic policies that generate real external shock converge over the medium term will be identified. This information will become effective in the formulation of appropriate economic and financial policy in the event of a real shock to the Chinese economy.

(3) Train human resources to survey and analyze financial trends
In order to expand the collection and analysis of financial statistics as detailed above, it will be necessary to provide training on financial statistics, economic models, and analysis of financial trends.

Points to be considered

Action plan 14: Foster human resources for the financial sector in the regions

Background

(1) The necessity of human resource development at small and mid-size financial institutions in the regions
Bank clients in the western region have powerful borrowing needs but loans are difficult to procure. This trend is particularly conspicuous among SMEs and farmers. One of the primary reasons for this is that financial institutions lack competence in financial surveys and debt management. Moreover, the knowledge and skills of fund managers concerning agricultural financing will need to be enhanced so that the role of the rural credit cooperatives in extending funds to farmers can be magnified in the future.

(2) The shortage of financial officers in SMEs and local government
One of the reasons that SMEs have difficulty in securing loans from financial institutions is their poor performance in terms of management and financial statements. SMEs lack knowledge and expertise on finances and the personnel in charge of finance. Knowledge on the funding of regional development is also in short supply within local government.

Recommendations

Objectives
Through the following initiatives, to improve the financial services of small and midsize financial institutions in the regions, enhance the fund-raising environment for businesses will lead to improvement of the functions of local financial institutions and vitalization of local economies.

(1) Develop the systems and organizational framework needed to train financial officers
It is recommended to introduce an accreditation system for financial human resource training in China, to establish a network for educating and training financial officers, and to expand training programs targeting small and midsize financial institutions.

(2) Expand the education and training system for small and midsize financial institutions in the western region
It is recommended to build awareness of the importance of human resource development in small and

midsize financial institutions (city banks (commercial), rural commercial banks, rural cooperative banks, rural credit cooperatives, etc.), and to promote expansions to the education and training of small and midsize financial institution employees.

(3) Train financial officers in SMEs and local government units in the western region
It is recommended to train financiers in SMEs and local government and to cultivate employees with the potential to become chief financial officers (CFO), i.e. personnel with the ability to formulate business plans and procure funds from financial institutions

Responsible organizations
China Banking Regulatory Commission (CBRC), People's Bank of China (PBC), China Banking Association (CBA), China Financial Education Development Foundation

Specific implementation procedures

(1) Introduce a grade system for financial education
The introduction of a grade system has the following merits: 1) it can be used to standardize personnel assessment criteria throughout the industry, 2) it can be used to reduce training costs for small and midsize financial institutions, and 3) it can be used to cultivate an education and training service industry.

(2) Establish an education and training network for financial officers in the western region

1) Establish regional financial training centers
For small and midsize financial institutions, the cost of establishing in-house training centers is excessive and there are limits to curriculum development abilities. Accordingly, to provide small and midsize financial institutions with the opportunity to receive education and training it is proposed that "regional financial training centers" be established to take a central role in training financial officers throughout the region. The local banking association, rural credit cooperative organization, or education and training institution should take the initiative and establish a "regional financial training center" based on actual circumstances in each area.

2) Establish a central financial training center
A "central financial training center" should be set up to control and support the "regional financial training centers". Its primary functions would be to identify education and training needs from the perspective of general financial industry trends, to develop a standard curriculum for education and training, to promote exchanges with and gather information on foreign financial institutions, to provide information to local financial training centers, to promote exchanges with major training institutes / companies in the financial sector, and to submit reports to government financial organizations.

3) Expand education and training programs for small and midsize financial institutions
(1) Develop and implement education and training programs that correspond to progress in financial deregulation and innovation in financial technologies; (2) develop and implement education and training programs for agricultural and SME financiers; (3) implement distance education programs, etc.

(3) Expand and improve the education and training systems of small and midsize financial institutions in the western region
Commercial banks, rural credit cooperatives and so forth, need to reform their personnel systems so as to attract the outstanding managers and experts needed to execute modern business management and such candidates, and, simultaneously, to introduce staff training systems.

From the above standpoint, the Banking Regulatory Commission, local banking associations and rural credit cooperative organizations should encourage small and midsize financial institutions to improve their financial services and increase efficiency through personnel system reform and human resource development.

(4) Cultivating financial officers in SMEs and local government units in the western region
To expand and diversify funding channels for western development, it will be necessary to introduce new financial technologies and strengthen risk management. However, there is a shortage of knowledge and

experience in dealing with such new funding techniques among companies and local government units in the western region, i.e. those entities with funding requirement. In order to eliminate this problem, the aforementioned regional financial training centers should provide training to financial officers employed by SMEs and local governments.

Points to be considered

20. Action plans for the development of legal infrastructures relating to financial system reform and development

20-1: Enactment of the Basic Law on Regional Development and Regulations for Western development

Background

There are no basic laws covering western development policy, and the administrative regulations governing the Western Development Strategy have all been issued in the form of standards, under which policy is formulated and implemented. In order to guarantee transparency and to maintain stability and consistency in western development, which constitutes a key national policy, there is an urgent need to establish a stable legal platform.

Recommendations

The establishment of a "basic law on regional development" will not only cover wide-scale regional development, i.e. that in the western, northeastern and central regions, but will also provide a legal platform for application to national policy covering the development of smaller areas (regions).

(1) Establish the Basic Law on Regional Development (tentative name) with a view to creating the legal foundations for regional development, and define general principles covering the formation / decision-making process and means of execution for development policy.

(2) Draft and implement timely regional development policy for specific regions on the basis of the Basic Law on Regional Development.

(3) Provide detailed and highly specific policy for individual sectors and/or provinces in ministry and/or commission regulations and regional legislature.

Implementation

Main departments, etc.: National Development and Reform Commission (NDRC), Departments and/or commissions responsible for regional development

Implementation: mid-term

20-2: Review current legislation on western development and overhaul the legal system

Background

There are no basic laws covering western development policy, and the administrative regulations governing the Western Development Strategy have all been issued in the form of standards, under which policy is formulated and implemented. In order to guarantee transparency and to maintain stability and consistency in western development, which constitutes a key national policy, there is an urgent need to establish a stable legal platform.

Recommendations

Check all laws, administrative regulations and regional legislation pertaining to western development, and establish a coherent and robust legal system covering the Western Development Strategy via the revision, cancellation and/or consolidation of same.

(1) Supplement, amend or revise specific laws (administrative regulations, departmental / commission rules) relating to the promotion of industry, agriculture, water supply, investment, tourism, education, science and high-tech industries, etc.

(2) Enact new laws to ease conditions for market entry, eliminate discrimination towards the private economy, promote the development of the non-public economy and promote the development of economics under all forms of (corporate) ownership.

(3) Summon legal officers from departments and/or commissions dealing with the provision of Regulations for western development and from the provinces and autonomous regions located in the western region and set up a working group under the jurisdiction of the Legislative Affairs Office of the

State Council to establish a new, all-embracing legal system shortly after the new regulations are enacted.
Implementation Main departments, etc.: Legislative Affairs Office of the State Council, related departments and/or commissions, and the legal officers in each of the provinces / autonomous regions in western China. Implementation: mid-term

20-3: Establish the Basic Law on Policy-based Financial Institutions (tentative name)
Background There are indications that policy-based finance in the western region is commercializing and that this is undermining the supporting role played by national policy. In order that policy-based can execute their primary business (i.e. policy-based finance), such institutions need to be regulated under law and efforts made to improve and promote policy-based financial services.
Recommendations Enact the Basic Law on Policy-based Financial Institutions to establish the legal foundations for policy-based banks, and to facilitate the early establishment of policy-based banks, institutional financial institutions, regional development financial institutions and development funds, and transparent and standard operations.
Implementation Main departments, etc.: People's Bank of China (PBC), China Banking Regulatory Commission (CBRC), Ministry of Finance, and the National Development and Reform Commission (NDRC) Implementation: mid-term

20-4: Develop regulations on the basis of the Basic Law on Policy-based Financial Institutions
Background The establishment of the Basic Law on Policy-based Financial Institutions could result in conflict with the content of current State Council notification relating to the establishment of policy-based banks. The early enactment of regulations that conform to the Basic Law on Policy-based Financial Institutions and govern the establishment and operation of policy-based financial institutions to be established in the future will also be necessary.
Recommendations (1) Establish regulations covering the business categories, fund procurement, finances, budgeting, internal auditing and reporting responsibilities of existing policy-based banks. (2) Establish regulations to cover the business categories, fund procurement, finances, budgeting, internal auditing and reporting responsibilities of policy-based financial institutions, in the event of new establishment.
Implementation Main departments, etc.: People's Bank of China (PBC), China Banking Regulatory Commission (CBRC), Ministry of Finance, National Development and Reform Commission (NDRC), related provincial governments, policy-based banks Implementation: mid-term

20-5: Develop a legal system to promote regional banks
Background There is a need to cultivate and promote community-based financial institutions. Regional financial institutions play a particularly significant role in the financing of regional development, and affecting expansions is critical.
Recommendations To ease the establishment of local commercial banks, enact a "law to promote local commercial banks (tentative name) incorporating clauses that review the regulations on minimum capital / capital adequacy ratio requirements contained in the Amended Law on Commercial Banks, and additional provision on more rigorous auditing systems and mandating the public disclosure of financial information, thereby furnishing the legal foundations for measures to promote small and medium-sized banks in the regions.

Implementation Main departments, etc.: People's Bank of China (PBC), and the China Banking Regulatory Commission (CBRC) Implementation: mid-term

20-6: Develop laws on issues of local government bonds
Background There is a need to amend and/or revise laws governing issues of local government bonds and to enact administrative regulation relating to this matter.
Recommendations (1) Amend the provisions of Article 28, section 2 of the Budget Law and revise the de facto ban on the issuance of local government bonds. (2) Amend the provisions of Article 8 of the Securitization Law, to enable local governments to guarantee local government bonds with the permission of the State Council. (3) Based on these amendments, the State Council should enact "regulations on the issue of local government bond" to cover issuing procedures, methods of issue and redemption, grading systems, and reporting obligations, etc.
Implementation Main departments, etc.: Ministry of Finance, National Development and Reform Commission (NDRC), municipal and/or provincial governments under direct State rule Implementation: mid-term

20-7: Legislate local government debt supervision / management
Background In the event that local governments are authorized to issue bonds, the debt status of these government units will require rigorous and judicious management.
Recommendations Enact the Law on the Management of Local Government Debt (tentative name), define effective and workable regulatory indicators, assessment systems and reporting systems covering local government debt (including external debt) and strengthen the regulatory framework.
Implementation Main departments, etc.: Ministry of Finance, National Development and Reform Commission (NDRC), municipal and/or provincial governments under direct State rule Implementation: mid-term

20-8: Develop the legislature to enable PPP (Public-Private Partnership)
Background To facilitate the funding of PPP, the legal system governing the adjustment of complex rights and obligations relationships, the development of various guarantee systems, the securitization of project assets, the processing of priority and subordinate terms, and bankruptcies, etc. will need to be completed.
Recommendations (1) Establish the Realty Appraiser Law (2) Establish the Civil Conservation Law and the Civil Enforcement Law (review / adjust the provisions of the Civil Procedure Law, and redraft as the Civil Conservation Law and the Civil Enforcement Law or as a separate "Civil Conservation Enforcement Law")
Implementation Main departments, etc.: Legislative Affairs Committee of the State Council Implementation: short- to mid-term

20-9: Develop the legal platform to facilitate development of financial risk management systems
Background In developing financial risk management systems, it is essential to establish a legal system governing both legal risk (protection of contractual rights and obligations of the parties to a financial transaction) and credit risk (bad-debt risk).
Recommendations (1) Establish the Realty Appraiser Law (2) Establish the Civil Conservation Law and the Civil Enforcement Law (review / adjust the provisions of the Civil Procedure Law, and redraft as the Civil Conservation Law and the Civil Enforcement Law or as a separate "Civil Protection Enforcement Law") (3) Revise the "bankruptcy law" (combine provisions relating to corporate bankruptcy contained in the Company Law and the Principles of Civil Law and consolidate under the existing Bankruptcy Law, which applies only to bankruptcies of wholly privately-owned companies)
Implementation Main departments, etc.: Legislative Affairs Committee of the State Council, People's Bank of China (PBC) Implementation: short- to mid-term

APPENDIX

The Members Contributed to the Study on Financial System Reform for the Western Region Development in the People's Republic of China

(Honorifics are omitted, and affiliations indicated are at the time of the Study.)

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Motokazu Shichijo	Developmental financial system
Reijiro Hashiyama	Technology transfer 2 (Developmental financial system)
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Ayako Ishiwata	Poverty alleviation and microfinance
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Keiji Adachi	Development of industrial infrastructure
Hiroto Tsuge	Promotion of investment
Kazutomo Abe	Construction of economic models
Toshiyuki Tsukasaki	Financial risk control
Aoi Iwana	Work coordination