

## INVESTMENT AND FINANCING MODE AND MECHANISM ADOPTED BY STATE-OWNED INVESTMENT GROUPS IN CHONGQING, CHINA

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Chongqing Municipality is a well-known historical and cultural city in China and has a civilization history of over 3000 years. Opened to foreigners first in 1895, it has been the earliest trade port ever along the Yangtze River area. During the World War II, Chongqing became the wartime capital of China and also headquarters of the Allied Forces in the Far East. It was the political, economic and cultural center of China and Asia as well. Chongqing was administrated under Sichuan Province. In 1997, Chongqing became a direct-administered municipality<sup>1</sup> under the central government, covering a total area of 82,400 square kilometers, the city consists of 40 districts and counties (cities) with a population of 31.54 million<sup>2</sup>. The central part of Chongqing, where 5 million people inhabit, is located at the confluence of the Yangtze and Jialing Rivers. Such a geographic location makes the city a world-known "city of mountains and rivers". The implementation of the "West China Development Strategy"<sup>3</sup> started from 2000 by the central government, has provided Chongqing, the only municipality in West China, an unique opportunity to speed up its social and economic development. Currently, Chongqing is the metropolis, important industrial and commercial base and education, science /technology and cultural center not only on the upper reaches of the Yangtze River, but in the whole western part of China.

### I. Comparative Development Advantages

Chongqing is an investment attraction with greatest potential among extra-large cities in West China with five advantages as follows:

i. It enjoys advantageous geographic position. Chongqing, a linking point between west and east, is located at the core area on the upper reaches of the Yangtze River. It is also an important

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<sup>1</sup> There are four municipality cities under central government's direct administration: Beijing, Shanghai, Tianjing and Chongqing.

<sup>2</sup> From Chongqing Statistical Year Book 2005.

<sup>3</sup> West China area includes 12 municipalities and provinces such as Chongqing, Sichuan, Yunan, Qinghai, Inner Mongolia and Guangxi. It covers 6.85 million Km<sup>2</sup>, accounting for 71.4% of the whole country and its population is 367 million. Due to some natural, historical and social reasons, its development is comparatively backward as are the majority of people living in this area.

area for the implementation of the “West China Development Strategy”.

ii. It boasts a sound infrastructure base. Chongqing is the only transportation hub in west China combining 3 transportation modes in place. Several pillar railways and expressways across the mainland link Chongqing with most of the cities inside the county. Cargo ships with more than 3000 ton capacity can smoothly go up the Yangtze River to Chongqing port and Chongqing Jiangbei International Airport is also listed as one of the key national airports. In addition, with large scale production of coal and natural gas, energy provision is guaranteed.

iii. It has a strong industrial base. Chongqing is one of China’s old industrial bases with pillar industries like automobile manufacturing, chemicals & pharmacy, building materials, food manufacturing and tourism expanding rapidly. In addition, hi-tech industries such as information technology, biological engineering, and environmental protection technology are also speeding up their development.

iv. It has strong scientific, technical and educational back-up. There are more than 1000 scientific research institutions, 29 colleges and universities and 600,000 research staff residing in Chongqing<sup>4</sup>.

v. It has a huge potential market. In addition to its large population, the improvement of people’s living standards and living condition, resettlement of town workers from the Three Gorges reservoir area, large-scale infrastructure construction, ecological environment protection and pollution control, together with upgrading of old industrial base will certainly produce great consumption and investment demand.

Seizing the historic opportunity of “West China Development” by the central government, Chongqing will follow its strategic plan of building “3 centers, 2 hubs and 1 base”<sup>5</sup> to speed up its social and economic development and bring into full play role as the strategic prop in the development of west China, the window to the outside world and the radiator and a driving force to its surrounding areas.

## **II. Great achievements made in economic and social development during the past nine years since Chongqing’s status was upgraded**

The Chinese central government’s decision to upgrade the status of Chongqing, build the Three Gorges hydropower project and develop the west region has been considered a significant historic opportunity for Chongqing’s development. Having seized this great historical opportunity, the city is experiencing rapid, sustained and healthy socioeconomic development and a quick expansion in the overall size of its economy. In the past nine years since Chongqing’s status was upgraded from a city under the administration of Sichuan Province to a

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<sup>4</sup> Chongqing Statistical Year Book 2005.

<sup>5</sup> Three centers are commercial & financial, scientific & educational and information center. Two hubs are transportation and communication hub; one base refers to modern industrial base funded on high-tech industry.

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direct-administrated municipality under central government, which has exposed Chongqing to more opportunities in foreign direct investment, government input, etc, Chongqing achieved an average annual GDP growth of 10.0%. The period from 2000 to 2005 registered an annual growth of 10.5% with a total GDP of RMB306.9 billion<sup>6</sup>. Chongqing's financial revenue has also increased rapidly from the mere RMB5.48 billion in 1997 to RMB39.5 billion in 2005, registering a growth of 6.2 times. In the past five years, particularly, Chongqing's fiscal revenue has kept growing at an annual rate of over 30%. While accomplishing a rapid growth in these two aspects, Chongqing has undergone the following five major changes in its economic structure:

i. The industrial structure has changed significantly. In 1996, agriculture accounted for as much as 24% of the municipal economy. After 9 years of development however this proportion has dropped by 9 percentage points whereas the weight of industry has gone up by 7 percentage points. Right now, the secondary and tertiary industries account for 85% of our economy, which leads to a rationalized and optimized industrial structure<sup>7</sup>.

ii. The ownership makeup has changed significantly. Being one of China's major traditional industrial bases, Chongqing had a ratio of 75:25 in the public sector to the non-public sectors of its economy at the time when its status upgraded. Up to the end of 2005, however, this ratio became 49:51, with the state-owned part accounting for only one-third. The rapid growth of non-public sector has played an important role in the healthy development of the municipal economy.

iii. The industrial economic structure has changed significantly. In 1996, the gross output of industry registered RMB105.6 billion, but by the end of 2005 that number reached RMB350.8 billion, up by 2.5 times. In 1996, the output value of high-tech products accounted for only about 3% of the city's total industrial output. By the 2005, it reached 26.6%, up by 8.8 times. Currently, the net capital of Chongqing's industry is approximately RMB120 billion, yielding a return rate of around 10%. The overall index of industrial efficiency is 138.5, which is 74.5 percentage points higher than the level in 1996<sup>8</sup>.

iv. The structure of financial assets has changed significantly. In 1997, the overall effective loan from financial institutions was RMB91.4 billion, with Non Performance Loan (NPL) rate of 36%. By the end of 2005, however, this level increased to RMB377.9 billion, up by nearly 3 times, with NPL rate dropped to below 8.5%, thus making Chongqing a city with relatively good financial atmosphere in the country and the best in the west region of China<sup>9</sup>.

v. The rural-urban ratio has changed significantly. Chongqing's territory exhibits a two-element structure characterized by "a large urban part plus a large rural part". In 1996,

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<sup>6</sup> From 2005 Chongqing municipality economy and social development statistical announcement.

<sup>7</sup> From Chongqing Statistical Year Book 2005.

<sup>8</sup> *ibid.*

<sup>9</sup> *ibid.*

Chongqing's urbanization rate was only 28% and this level became 45.2% by the end of 2005, which was higher than the national average<sup>10</sup>.

The profound changes in the above aspects mark the excellent structure and tendency in socioeconomic development of Chongqing.

### **III. Investment constitutes an important driving force in the fast socioeconomic development of Chongqing**

Recent years' intensified investment activities have been the major driving force spurring the fast economic growth and 5 major changes in the economic structure in Chongqing. During the 9-year period, investments in fixed assets increased by an average of 22.6% each year and it has even gone up to an average of 25.1% yearly in the recent 5 years. In 1996, the volume of investments in fixed assets was approximately RMB32 billion, but in 2005 this figure became RMB200.6 billion, up by 6.3 times over that in 1996. According to the 11<sup>th</sup> five-year plan, total investment in fixed assets will be RMB1.3 trillion, maintaining an average annual growth rate of over 10%<sup>11</sup>.

Chongqing not only features a huge volume of investment each year but also boasts regularized sources of fund. The annual RMB200 billion investment volume comes mainly from five sources: first, the investment by the central and local governments, constituting about 12%; second, funds raised by domestic businesses, accounting for about 30%; third, funds provided by foreign businesses, accounting for about 14%; fourth, additional bank loans, accounting for about 42%; fifth, market financing from stocks and securities, accounting for about 2%<sup>12</sup>. We consider the portion of capital market financing too small and the volume of direct market financing will be further enlarged.

The major part of Chongqing's investments each year goes to the construction of infrastructure and development of the manufacturing and service industries. At present, 46% goes to infrastructure construction, 28% to manufacturing industry and 26% to service industry. In the next 5 years, further adjustment will be made to a ratio of 4:3:3 i.e. 40% for infrastructure<sup>13</sup>; 30% for manufacturing industry and 30% for tertiary industry such as real estates, culture, education and health care<sup>14</sup>. The eventual investment structure should be one oriented to industry and commerce, which meets various developing functions and market demands.

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<sup>10</sup> From 2005 Chongqing municipality economy and social development statistical announcement and 2005 Chongqing Statistical Year Book 2005.

<sup>11</sup> From Chongqing Statistical Year Book 2005.

<sup>12</sup> *ibid.*

<sup>13</sup> Infrastructure here refers to expressways, railroads, rural irrigation works, urban sewage treatment and garbage disposal facilities, etc.

<sup>14</sup> From 2005 Chongqing municipality economy and social development statistical announcement

#### **IV. Setting up a market-oriented financing/investing platform and mechanism**

In the planned economy era, the usual practice combined finance, investment and construction into a single whole. Since opening up and the overall reform started, especially after the 1990s, China's socialist market economy system has been gradually formed. Chongqing has accelerated the reform of its investment and financing system and set up a platform according to the requirement of market economy and public finance, on which the government provides guidance for state-owned enterprises to participate in the market-oriented investment and financing, which initiates the participation of the whole society in financing and investment. In recent years, Chongqing municipal government has helped establish and expand 8 major construction-oriented investment groups i.e. the urban construction investment company, expressway development company, highway construction investment company, real estate development group, construction investment company, development and investment company, water supply service company and water conservancy investment company as well as Yufu Assets Operating and Management Co., Ltd. These 8 investment groups together with Yufu Company are mainly dedicated to making investments in the construction of infrastructure planned by the government. In the background of an urgent public demand, weak market signals and inadequate market mechanism, the government-authorized investment makes the first move in the construction sector, which helps initiate the involvement of social investments. When the market signal becomes stronger and market mechanism is established, the state-owned capital then gradually withdraws. This practice on the one hand ensures the construction of government-designated priority projects, on the other hand, makes the state-owned capital play an effective role in terms of controlling, influencing and leading the development national economy. At the same time, the eight giant investment groups and the Yufu Company develop rapidly along the way.

*Firstly, the total size of assets of the eight investment groups has increased dramatically*

At the end of September 2003 when the Chongqing Municipal State-owned Assets Supervision & Administration Commission was founded, the total volume of Assets owned by the investment groups was only RMB33.9 billion, accounting for 23.5% of the total municipal state owned assets. At the end of 2005, however, the total assets of these groups amounted to RMB150.2 billion, up by 3 times and the portion it took in the municipal total increased to 40.7%.

*Secondly, the quality of assets owned by the investment group has improved considerably*

In 2003, these investment groups registered an average asset-liability rate (ALR) of over 70% and some of them had an ALR of as much as 90%. At the end of 2005, Yufu Company's average ALR was 58.6%, down by nearly 15 percentage points. All other investment companies registered an ALR of below 50%, the lowest one being only 13.4%, except Chongqing Expressway Development Company whose ALR was 70% for the reason that many of the

projects in which it had invested were still under construction. The financial structure of these companies becomes healthier. The risk of liquidation is low.

*Thirdly, the operating capability of the investment groups has increased dramatically*

By the end of 2005, two of the eight investment groups along with Yufu Company have registered a total volume of assets exceeding RMB30 billion, while seven of them had accumulated a total volume of over RMB10 billion each. In 2005, the eight investment groups and Yufu Company financed more than RMB47 billion in financial institutions, securities and bond markets and invested RMB28 billion in construction, accounting for 14% of the city's total investment in fixed assets and well over 30% of the total investment in infrastructure and public facilities. They played an essential role in investment and financing in this area.

#### **V. Three important measures to ensure the development and growth of the eight major investment groups**

The robust development and growth of the eight major investment groups in Chongqing are attributed to three important measures: 1. "Five inputs" i.e. government inputs through funds of national debt, land reserve, stock assets, stipulated fees and taxes levied; 2. "Three no's" i.e. no government guarantee for the investment groups' financing business, no enterprise guarantee to each other among these groups themselves and no funds are to be used other than their designated purposes in each of these groups; 3. "Three equilibriums" i.e. the investment groups must ensure the equilibrium between assets and liabilities, cash flows, and investment and financing. The "five inputs" are government policy measures for increasing the capital capacities and credibility of the investment groups; the "three no's" serve as a "firewall" to prevent financial risks by separating administration from capital and enterprise operation; the "three equilibriums" is the rule to be closely observed by the investment groups in order to ensure sustained and normal operation. The above-mentioned three measures constitute the basic framework for Chongqing's investment groups to regularize operation and ensure healthy development.

##### 1. "Five inputs" to strengthen the overall capabilities of the investment groups

- (1) Input through fund of national debts: national debt Investments are arranged by the central government each year. In the past few years, a total amount of RMB20 billion raised in the form of national debt was allocated to hundreds of projects in Chongqing's 40 districts and counties. Now, this amount has been collected and distributed to the pertinent investment group for uniform management. The unified input of these funds has increased the capital volume of these investment groups by over RMB20 billion. Then when this extra amount is used to secure a bank loan at a ratio of 1:1 and it generates an additional amount of RMB20 billion. On the whole, the input of national debt fund in recent years has resulted in a total volume of

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assets of over RMB40 billion for these investment groups. During the 11<sup>th</sup> five-year plan period, an annual national debt fund of RMB4-5 billion and a total of RMB20-25 billion is expected to be input to Chongqing. Following the existing course of action, these inputs will be distributed to the respective investment groups to form fresh additions to capital fund.

- (2) Input of stipulated fees levied: A typical example of this is the input of tolls to the Urban Investment Company. The total amount of tolls levied last year was RMB600 million and this figure is expected to be RMB700 billion this year and next year. The road maintenance fee levied thus goes to Chongqing Expressway Development Company while, of the urban construction and maintenance fees, the part used for urban construction goes to the pertinent investment group.
- (3) Input of land reserve: The municipal government allows some investment group to reserve land and use the revenue generated by the land reserve as a capital input. The municipal government gives the Real Estate Group and Urban Investment Company the power to act as a municipal-level land reserve center, which currently has reserved over 100,000 Mu<sup>15</sup> of land.
- (4) Input of stock assets: In the past decades, the government constructed a great deal of tangible assets such as roads, bridges, water plants, garbage disposal facilities, etc. These tangible stock assets, once allocated to the pertinent investment groups, become their fixed assets. In this way, the stock assets are actively utilized and the registered volume of assets of the investment groups expands quickly. In the past few years, more than RMB10 billion worth of stock assets have been allocated to the investment groups.
- (5) Input by tax refunds: The government refunds construction and operation taxes, etc. levied from investments made in infrastructure and public facilities. Approximately several hundred million RMB of taxes are refunded to the investment groups each year, which become part of their assets.

### 2. The “three “no’s” measure constitutes a firewall

- (1) The government finance provides no financing guaranty for the investment groups. The measure is to prevent municipal-level financial liability risks and protect the bank and other financing institutions. While the government and its agencies support the development of these investment groups, they must also draw a clear boundary line between the two. The separation of government administration from enterprise’s operation must be strictly observed. Otherwise, the government-enterprise boundary line would then be blurred, thus reducing the

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<sup>15</sup> Mu: a Chinese land measure, equal to 733 ½ square yards.

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credibility of the government and possibly resulting in bad bank accounts and mounting pressure on the government finance. As a matter of fact, government help is really to solve enterprise's problems by strengthening its capital capability and uplifting its level of credibility, in the meantime, let the bank award credits based on market rules and crediting principles.

- (2) Investment groups are not allowed to provide financial guaranty to each other. Every investment group has a certain degree of credibility but if they provide guaranty for each other, then the bankruptcy of one group would affect others and result in a widespread calamity. Conversely, if they do not mutually guarantee, the collapse of one would not affect others and the problem would be easier to solve.
  - (3) Special-designated funds area not allowed to be used other than their purposes. Every investment group has some special-purpose funds, which are actually owned by the government finance but provided to the enterprise for special purposes. Therefore, these funds must be used for their designated purposes only and no excuses are allowed.
3. The “three equilibriums” ensure the continuous healthy development of investment groups
- (1) Equilibrium between assets and liabilities: The investment group shall keep the healthy asset-liability ratio (ALR: Liability/Total Asset), ideally at about 50%. This ratio has been a basic principle to be followed by the investment groups. However, a lower ALR does not always mean a good thing. It is not necessary for a group to keep the ALR at 40%, 30% or even lower. On the other hand, it is of course not good to let the ALR go over 80% as this may lead to the risk of collapse. For instance, the eight investment groups in Chongqing have secured a total amount of bank credits of RMB260 billion, but the actual amount of bank loans is of some RMB80 billion which accounts for only approximately 1/3 of the credits awarded. As the size of capital increases gradually in the process of development, the amount of liabilities will increase accordingly, these investment groups are required to maintain healthy asset-liability ratio.
  - (2) Equilibrium of cash flows: The equilibrium of cash flows is another essential principle to be followed by investment groups and enterprises in order to operate and develop properly. The investment groups should adjust the demand and supply of cash to achieve an equilibrium between them and a proper turnover of cash flows. Investment Groups are required to take a conservative approach in their operating, investing and financing activities so as to maintain healthy cash inflow and outflow.
  - (3) Equilibrium between input and output: Although investment groups serve as an

important leverage for the government to control and adjust the layout and structure of construction and development and take the government objectives as their own and are bound to accomplish the task assigned by the government, they are not supposed to meet all specific requirements of the government unconditionally. Instead, they should stick to the economic law and market rules. Before accepting the construction investment task assigned by the government, they should take into consideration the balance between their capital capacity and financing capability. When the government assigns a construction investment task, both the government agency and the investment group should make analysis of its reasonability and achieve the equilibrium between the input and output or the source of input capital. When it is impossible to achieve equilibrium, plans should be made to achieve it in the future. If the government fails to reach the input-output equilibrium when assigning a task to the investment group and thus bring about tremendous financing difficulties or creditability crisis to the investment group, the group is encouraged to state its views and require a reassignment of projects by the government.

### **VI. The government is by no means to set up and expand investment groups for monopoly purpose.**

In the western part of China, what is relatively underdeveloped is the infrastructure, public facilities and social cause. There has been a big demand for a fast pace of development in these fields in order to ensure fast socioeconomic development in the west region and quick improvement of working and living conditions for the people there. However, as these fields involve a great size of investment and take a long repayment time with low or even no profit return in the near future, private and foreign capital are reluctant to get involved. Therefore when the market signal is weak and the market mechanism incomplete, the municipal government of Chongqing takes an active role in setting up a number of large state-owned investment groups, allowing them to invest in these fields. This does not necessarily mean that these state-owned investment groups would monopolize these fields. Rather, they will gradually withdraw when market signals become strong enough to attract social attentions, no matter if projects are under construction or have been completed and put into operation. By then, the state-owned capital will be switched to new fields necessary for the national economy and people's livelihood. For example, in the past two years, Chongqing Expressway Development Company has handed over the airport expressway and Chengdu-Chongqing expressway; Water Service Group has founded the Sino-France Water Service Investment Company with the French Suez Group. 60% of the fixed assets of Chongqing Water Service Group was purchased with cash and stock held by the foreign counterpart, which broke the limit set by the government that the stock held by foreign investor(s) in a joint venture engaged in water service shall not exceed 50%.

## **VII. Chongqing's state-owned investment groups serve as a good platform and partner for foreign capital in Chongqing**

Practice has shown that the financing and investment mode adopted by Chongqing's state-owned investment groups is the best one necessary to facilitate socioeconomic development in the west region of China at the present stage and the best platform and partner for foreign capital to seek expansion in Chongqing. Currently, Chongqing's state-owned investment groups have a clear property right relationship, complete management system, good corporate creditability and strong capital capability. During the last few years, they have tremendously involved in infrastructure construction, including utility, transportation and other fields, e.g., environment, etc, which support building a healthy and strong investment environment, attracting more private funding. The Chongqing's development mode – setting up investment groups to take the charge of the investment in these areas – has been successful. This mode of operation and its fast growth have caught the attention of the central government and heated response from other parts of China.