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Report No. P-788

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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

EXECUTIVE DIRECTORS

ON A

PROPOSED LOAN

TO THE

CHINA DEVELOPMENT CORPORATION

WITH THE GUARANTEE

OF THE

REPUBLIC OF CHINA

March 25, 1970

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT AND RECOMMENDATION OF THE PRESIDENT
TO THE EXECUTIVE DIRECTORS ON A PROPOSED
LOAN TO THE CHINA DEVELOPMENT CORPORATION
(CDC)

1. I submit the following report and recommendation on a proposed loan in an amount in various currencies equivalent to \$18.0 million to the China Development Corporation (CDC).

PART I - HISTORICAL

2. The Government of the Republic of China and CDC have asked the Bank for a loan of \$18.0 million to replenish CDC's foreign exchange resources. The Borrower would be CDC, a private development finance company providing long-term finance to industry.

3. The proposed loan would be the fourth Bank Group operation to assist CDC. The proceeds of a \$5.0 million IDA credit made to the Government in 1961 were re-lent to CDC; subsequently two Bank loans - each of \$15.0 million - were made directly to CDC in 1964 and 1967. The IDA credit and the first Bank loan are fully disbursed. The second loan has been fully committed. The proposed loan is estimated to cover CDC's foreign exchange requirements till the end of 1971.

4. Negotiations were conducted in Washington from March 2 to March 4, 1970. The Government was represented by Mr. Martin Wong (the Minister Counselor) and Mr. T. W. Hu (the Commercial Attache) of the Chinese Embassy. The Borrower was represented by Mr. Felix Chang and Mr. C. P. Liu, the President and Deputy Controller respectively, of CDC.

5. The following is a summary statement of Bank loans and IDA credits to China as at February 28, 1970:

<u>Loan or Credit No.</u>	<u>Year</u>	<u>Borrower</u>	<u>Purpose</u>	<u>Amount (net of Cancellations)</u> (US\$ million)		
				<u>Bank</u>	<u>IDA</u>	<u>Undisbursed</u>
6	1961	China	Harbor Dredging		2.2	-
7	1961	China	Ground Water		2.0	-
9	1961	China	Water Supply		4.0	-
17	1961	China	Industrial De- velopment (CDC)		4.9	-
356	1963	China	Deep-sea fishing	7.6		-
397	1964	CDC	Industrial De- velopment	14.9		-
409	1965	China	Railways	17.8		1.4
498	1967	China	Deep-sea fisheries	6.9		1.2
506	1967	DGT	Communications	12.5		11.5
508	1967	CDC	Industrial De- velopment	15.0		6.1
524	1968	China	Railways	17.5		4.5
574	1968	Taipower	Power	50.0		47.2
603	1969	China	Railways	31.2		27.9
Total net of cancellations				173.4	13.1	
of which has been repaid to the Bank and others				6.6		
Total now outstanding				166.8		
Amount sold			8.6			
of which has been repaid			1.9	6.7		
Total now held by Bank and IDA				160.1	13.1	
Total undisbursed				99.8	-	99.8

6. Disbursements on three loans - those for the first and second railway projects (409-CHA and 524-CHA), and the telecommunications project (506-CHA) - are behind schedule and their closing dates have been extended. The first railway loan included financing for a new marshalling

PART III - THE PROJECT

9. An appraisal report entitled "Appraisal of the China Development Corporation" (DB-63a, dated March 19, 1970) is attached.

10. CDC was established in 1959 as a private development finance company to assist in the formation, modernization and expansion of private industrial undertakings. As of December 31, 1969, it had approved loans for 415 projects amounting to about NT\$3 billion (\$75 million) and had on that date a loan portfolio of NT\$1,477 million (\$37 million). CDC's equity portfolio stood at NT\$212 million (\$5.2 million) at the end of 1969. During the past few years, CDC has provided about 46 percent of total outstanding loans by financial institutions to the private sector for capital investment. Another indication of CDC's importance to the country's industry is the fact that in 1968 CDC's clients exported goods worth about \$151 million, i.e. nearly 18 percent of China's total exports. CDC is the only institution in China which provides long-term finance exclusively for the private sector and the Bank is, at present, its only prospective source of foreign currency.

11. CDC is well-managed. The staff is competent and its efficiency compares favorably with other development finance companies. The standard of appraisal work and follow-up procedures is satisfactory. In view of this, the free limit for sub-loans for which CDC would not be required to obtain prior approval from the Bank would be raised from \$500,000 to \$750,000. The aggregate amount allocated for sub-loans below this free limit will be \$6.0 million - one-third of the proposed loan.

12. CDC's loan portfolio is of good quality; a few potentially bad debts are amply covered by reserves. CDC's equity portfolio is sound and its profitability has shown satisfactory improvement over the past few years; at the end of 1969 it amounted to 12 percent of CDC's total portfolio. CDC increased its own share capital by 50 percent through the issue of stock dividends in 1967 and 1968. CDC's equity (share capital and share reserves) now amounts to NT\$311 million (\$7.8 million) and total assets to NT\$1,917 million (\$47.9 million).

13. Profits before taxes were 24 percent of average equity; profits net of taxes were 31.5 percent of CDC's share capital as of December 31, 1969. CDC's profitability is at a high level and compares well with other development finance companies associated with the Bank.

14. CDC's lending rate for foreign currency loans is 9 percent p.a. at present. An increase, possibly to 9.75 percent, is being considered by CDC's Board of Directors to cover the higher cost of its foreign exchange resources.

15. CDC's operations are expected to rise steadily during the next two years in response to expected maintenance of a high growth rate in the manufacturing sector and its exports. It is forecast that total lending will rise from the 1969 level of NT\$475 million (\$11.9 million) to NT\$557 million (\$13.9 million) in 1971. During 1970 and 1971 a total of NT\$725 million (\$18.1 million) will be required in foreign currency as against financing needs of NT\$1,070 million (\$26.7 million). These projections are regarded as reasonably conservative and their attainment should be well within CDC's capacity from an operational standpoint.

16. The proposed Bank loan is expected to cover CDC's foreign exchange needs till the end of 1971. CDC should also have enough local currency resources to support its lending operations during this period. Of the NT\$345 million required, NT\$187 million will come from repayments on loans made by CDC in the past, and NT\$102 million are expected to be realized from CDC's profits. The remaining NT\$56 million will come out of cash balances and temporary investments which amounted to NT\$166 million on January 1, 1970. To maintain its future operations CDC will need additional local currency resources in 1972. CDC's management is exploring ways and means to raise additional local funds. Bond issues, loans from postal savings and a possible increase of CDC's equity are among the alternatives being considered. CDC will inform the Bank by the end of 1970 as to what firm measures it proposes to take to raise additional local currency.

17. While CDC has made a significant contribution to the development of industry in Taiwan, it has not placed sufficient stress on its developmental functions. Conservative policies have generally been followed and priority has been accorded in its lending activities to traditional industries and established enterprises. The Bank has indicated to CDC that it should play a more active role in the field of assisting new industrialists and in the formulation of new projects. CDC should also endeavor to contribute to make the domestic capital market more active through underwriting commitments and by encouraging its clients to become public companies. CDC's efforts to contribute to the development of the domestic capital market have been thwarted by a number of factors outside its control. Among these are the depressed condition of the stock market and the natural disinclination of most businessmen to make their companies public, which is reinforced by an absence of incentives to do so. The Government feels the need to develop the capital market and is at present considering measures which will help to increase the mobilization of domestic resources and to re-activate the stock market.

18. CDC is at present considering several requests from its customers for foreign currency financing which it expects to meet from the proceeds of the proposed loan and a few expenditures for these sub-projects may be incurred before the signing of the Loan Agreement. Because CDC has at present no alternative foreign exchange resources, it is proposed to reimburse expenditures made on or after March 1, 1970 as long as they are not incurred more than 90 days before the receipt of the relevant withdrawal application by the Bank.

PART IV - LEGAL INSTRUMENTS AND AUTHORITY

19. The draft Loan Agreement between the Bank and China Development Corporation, the draft Guarantee Agreement between the Republic of China and the Bank, the Report of the Committee provided for in Article III, Section 4 (iii) of the Articles of Agreement, and the text of a Resolution approving the proposed loan are being distributed to the Executive Directors separately.

20. The draft Loan and Guarantee Agreements conform substantially to the pattern of agreements for loans to development finance companies.

PART V - THE ECONOMY

21. An economic report entitled "Current Economic Position and Prospects of the Republic of China" (AS-142a, dated September 11, 1968) was circulated to the Executive Directors on September 17, 1968.

22. According to preliminary estimates, GNP increased by 8.9 percent in 1969. Because of the damage caused by two typhoons, the 1969 growth rate is somewhat lower than that achieved in 1967 and 1968 (9.9 and 10.3 percent respectively) but is still substantially above the 7 percent target of the Government's Four-Year Development Plan. Per capita GNP increased by approximately 8 percent in both 1968 and 1969 to a level of about US\$320 equivalent at current prices. The population growth rate is about 2.3 percent and on a declining trend as a result of the Government's active family planning policy.

23. Manufacturing and construction have consistently been the fastest growing sectors of the economy. The output of the manufacturing sector increased by 20 percent in 1968 and 18.5 percent in 1969 in response to progress in new and technically advanced industries. The industrialization of the economy is evidenced by the fact that the share of manufacturing in GNP was 30.3 percent in 1968 and about 32 percent in 1969, mainly at the expense of the share of agriculture, which was 24 percent in 1968 and 21 percent in 1969.

24. Merchandise exports increased by 26 percent in 1968 and 32 percent in 1969 to a level of about US\$1,100 million equivalent. The share of manufacturing in total exports reached 62 percent in 1969. Among the exported goods, textiles continue to head the list followed by electrical products, plywood and manufactured wooden products. Total imports of goods and services increased by 26 percent in 1968 and by an estimated 17 percent in 1969 to a level of about US\$1,200 million equivalent. The largest item on the list of imported goods was machinery, closely followed by electrical materials and transportation equipment. While the deficit on goods and services account of about US\$100 million in 1969 is relatively small, it could conceivably

increase in the future as further efforts to expand China's exports encounter growing resistance in overseas markets. The reduction of receipts in case of a scaling down of the Vietnam war would be negligible since only 2-3 percent of total export earnings are related to the conflict.

25. The Government's Fifth Four-Year Plan (1969-72) emphasizes intensified industrialization, particularly by increasing investments in more capital intensive and technologically sophisticated industries. To overcome existing bottlenecks in transportation, power generation, urban facilities and technical and scientific education, the Government will have to make major investments in the current Four-Year Plan period. While industrial and agricultural growth can rely largely on domestic private savings supplemented by foreign credits and some foreign equity investment, Government savings need to increase to finance the necessary investments in economic and social infrastructure. A tax reform commission has been established under the Cabinet and new tax legislation has been drafted. The tax reform is expected to increase total Government revenues from 18.5 percent of GNP in 1968 to 21.6 percent in 1972. Government savings will rise from a negligible amount in 1968 to 2.6 percent of GNP in 1972. Total domestic savings are 21 percent of GNP and are expected to rise to 25 percent by 1972.

26. Official foreign exchange reserves were \$477 million at the end of 1969, having increased by approximately \$100 million during 1969; they are equivalent to about five months' imports. Annual debt service in 1968 was less than 6 percent of exports of goods and services. It is estimated that further foreign capital requirements, taking into account relatively less favorable terms of future foreign borrowings, will increase the debt service ratio to about 10 percent by the mid-1970's. Given the past record of progress and favorable prospects for future growth, the Republic of China is creditworthy for the proposed Bank loan.

PART VI - COMPLIANCE WITH THE ARTICLES OF AGREEMENT

27. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Bank.

PART VII - RECOMMENDATION

28. I recommend that the Executive Directors approve the proposed loan.

Attachments

Robert S. McNamara
President

March 25, 1970