The WTO and China's Financial System

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China has agreed to the fundamental principles for accession to the World Trade Organization (WTO) with its principal trading partners. The United States and the European Union have, over a period of months, completed the arduous negotiations to conclude these agreements. These two major agreements are very close in content and will become the blueprint for China's accession in 2001.

The financial sector provisions of the agreements provide for significant points of entry to the Chinese markets by foreign participants. But they embody protectionist principles that will inure to the detriment of China's development. China evidences a reluctance to permit foreign competition in the financial sector. Out of fear or insecurity driven by the weakness of its own financial sector, it seems to be hoping that delaying the onset of competition will be good for China.

But delay will not be good. Consider the experience of Japan. With the world's second largest economy, Japan's decade-long slump is characterized by a weak financial sector. Its weaknesses stem largely from protectionist behaviour adopted in the 1950s and prolonged beyond its useful life. For many years, foreign banking institutions were restricted by the Ministry of Finance and by cultural barriers from delivering competitive financial services. The pension fund management industry in Japan in the 1980s routinely under-performed the benchmarks established by pension fund managers overseas.[1] While the stock market in Japan soared through the 1980s, the crash in 1989 marked not only the end of the bubble but also more importantly the exposure of the hollowness of Japan's asset management industry. Had Japan allowed foreign pension fund managers to play a serious role in managing its wealth in the 1980s, activists among the managers might have prevented the emergence of the bubble. They might also have triggered long overdue reforms of corporate governance.

China has the opportunity to include shareholder activism and fiduciary principles in step with the country's accession to the WTO. But the provisions of China's WTO agreements will make this problematic. The result will be the prolongation of under-performance by China's money managers. Free of true foreign competition, they will go about their business of promoting "socialism with Chinese characteristics."

As China accedes to the WTO framework, it will enter into a set of agreements that provide commercial benefits to foreign and Chinese players. The benefits surely represent incremental gains over the pre-WTO framework, for under the new system China will be obliged to abide by international rules of the game, and will be judged by its

1. Richard Katz, *Japan: The System that Soured; The Rise and Fall of the Japanese Economic Miracle* (Armonk: M.E. Sharpe, 1998), pp. 333–34.

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compliance with those rules. This is a major improvement. But China is postponing an opportunity to reform the paradigm of capital. The existing paradigm is one where undifferentiated political and economic goals, captured in the expression "socialism with Chinese characteristics," inflict a tax on capital that condemns China to sub-optimal returns and drags down its growth. It will remain in place in the post-WTO Chinese economy.

Globalization plays little deference to sovereignty. Under globalization, investors enter into contracts with users of capital that establish the priority of shareholder value over vague, undifferentiated social and political goals. Recipients of such capital accept the conditionality that goes with these contracts. Sovereign states, with borders and rules governing the flow and uses of capital, lose their ability to impose their indigenous objectives arbitrarily. Sovereignty in this way is compromised. Democratization of capital conflicts with the established powers in China's "socialist" state and Japan's stakeholder value state.

Apart from globalization, China already faces stresses that are purely indigenous. Its population and environmental problems, the non-performing loans in the banking system, the corruption, the restructuring and bankruptcy of the state-owned enterprises (SOEs), are all sources of great stress. The ruling party is committed to maintaining stability in the face of these stresses, while providing a rate of economic growth that offers an attractive future to its citizens. It does not welcome sources of additional stress that would come from uncontrolled foreign competition or from the conditionality arising from uncontrolled capital investment from abroad. It rightly recognizes that more, rather than less, stress will come from these things. Hence the regime's reluctance to permit unconstrained foreign capital entering China is understandable. It is not simply a result of the Party's interest in preserving its power. The Party does after all pursue lofty moral purposes on behalf of the Chinese people that are worthy of support. Furthermore, China is operating from a historical context that supports a cautious attitude toward foreign capital. In the years since the Opium Wars, it has been frequently disadvantaged by well-capitalized foreign intruders from the West and the East, not to mention the less-well-capitalized north. Its national pride has been bruised by those experiences, and such cultural feelings and anxieties cannot be disregarded.

Nevertheless generating proper returns on capital is also important. China's future depends on creating an environment in which its own capital, the savings of its citizens, is invested well. Japan's experience in the 1990s, where so much economic value has been destroyed by poor fiduciary behaviour, is the example that China should study. Instead, China has adopted protectionist constraints on its WTO framework, postponing the day when "socialism with Chinese characteristics" will be scrapped. The price for this will be sub-optimal returns on *Chinese* capital. The important stakes in this game are Chinese, not foreign.

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China's Financial Markets on the Eve of WTO Accession

The Chinese "Glass-Steagall" law. In the United States, financial services are increasingly being provided by "financial supermarkets." The separation of the securities and banking businesses that the U.S. Glass-Steagall law imposed in 1933 is now gone. But in China the government has moved to reinforce the barriers between financial services categories. The Chinese refer to this as *fenye guanli*, or regulatory oversight according to separate industry lines, and *fenye jingying*, or management by separate industry lines. Banking, securities brokerage and underwriting, asset management, and insurance are all separate industries in China.

Separation of banking from other financial businesses was enacted in the Commercial Banking Law in 1995.[2] Article 43 of that law forbids commercial banks from participating in non-bank financial activities. Banks thenceforth began to divest their brokerage subsidiaries and to unwind their participation in trust and securities businesses.

A key purpose in China's "Glass-Steagall" legislation was to curb speculation in the securities markets. The Commercial Banking Law aimed at breaking the link between the banks and the securities markets, thereby hoping to eliminate much of the excessive speculation. As Amy Chunyan Wu has shown, however, much of the speculative "hot money" has actually passed through the state-owned enterprises, which are the principal borrowers of the banks. The new banking law does not address this abuse. Wu wrote, "overspeculation is an industry-wide phenomenon that can be specifically attributed to the unique features of China's 'socialist market economy with Chinese characteristics'."[3] In fact, she argued that the system actually encourages state-owned enterprises to speculate. They are bankruptcy-remote because of the implied support of the state. Therefore they can retain the gains they make from speculation and share any losses with the state.[4]

The other side of separate business regulation is inflexibility. Institutions who logically should trade with each other are forbidden to do so. A prominent example of this can be found in the government bond markets where insurers and banks and individuals and corporations, all of whom should be counterparties of each other for trading purposes, are not able to be. Since the natural trading counterparties are blocked off from one another, development of the government bond market has been stunted and distorted as a result. The distinctive financial services sectors are now operating in vertical pipes.

The scale of China's financial markets today. China's equity markets have been in operation since 1991. From a standing start, they have reached a total market capitalization of about 4.8 trillion *yuan* or about

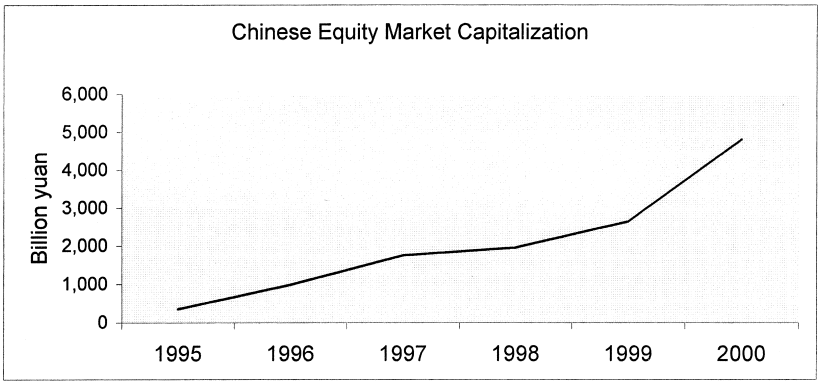
2. Amy Chunyan Wu, "PRC's commercial banking system: is universal banking a better model?" *Columbia Journal of Transaction Law*, No. 37 (1999), pp. 623–634.

3. *Ibid.* pp. 627–29

4. In the U.S., research has shown that much of the securities speculation that preceded the passage of Glass-Steagall came from low-cost credit. *Ibid.* p. 629.

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Figure 1: **Chinese Equity Market Capitalization**



Source:
Zhongguo tongji zhaiyao 2000 (*Excerpts from China Statistics 2000*) (Beijing: Guojia tongji ju, 2000).

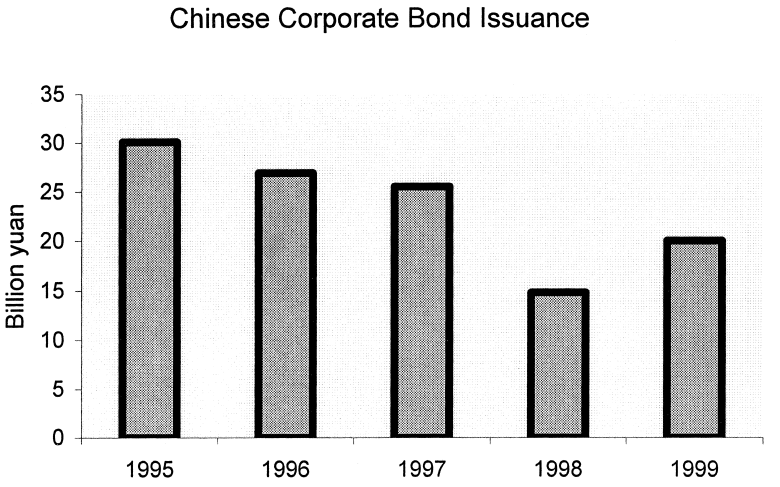
US$580 billion as of the end of 2000.[5] China's is the largest developing country stock market in the world.[6] And its growth rate is extremely rapid. Between 1995 and 1999, the market capitalization grew at a compound rate of about 66 per cent per annum, and in 2000 it accelerated even further (Figure 1). This shows a significant flow of capital from investors to the government (as seller) during the period. The number of new issuers expanded steadily. The total number of listed firms now exceeds 1,000, which is significant when compared with Japan's larger and older stock markets where only some 2,470 companies are listed.[7] It seems clear that China's market will easily surpass Japan's on this single benchmark within a few years.

In contrast to the equity market, the issuance of corporate bonds in China has stagnated over the past four years. This poor showing undoubtedly reflects the government's lack of interest in developing market-based direct finance. Corporate bond markets are more transparent than bank debt markets, and secondary market interest rates are unregulated. Furthermore, bankruptcy risk is more difficult to contain in a corporate bond market than in a bank market. The government for these reasons has shied away from using the debt securities markets to build its companies. Figure 2 reveals the mediocre performance of the bond markets in raising finance for China's enterprises. With an economy growing at 8 or 9 per cent per annum during the period 1995 to 1999, one would expect the use

5. See web site of the China Securities Regulatory Commission: www.csrc.gov.cn/CSRCsite/eng/tongjiku.
6. *Emerging Stock Markets Factbook 2000* (Standard & Poor's Corporation, New York, 2000).
7. *Ibid.*

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Figure 2: **Chinese Corporate Bond Issuance**



Source:
Zhongguo tongji zhaiyao 2000.

of bond markets for corporate financing to have increased during the same period, but it actually declined.

The treasury bond market is about 15 times larger than the corporate sector. Treasury bonds are issued by the Ministry of Finance to pay for China's growing fiscal deficits. The government has encouraged the development of this market, and has experimented over recent years with different ways of regulating and running it. Figure 3 shows the steady and rapid build up over the past five years.

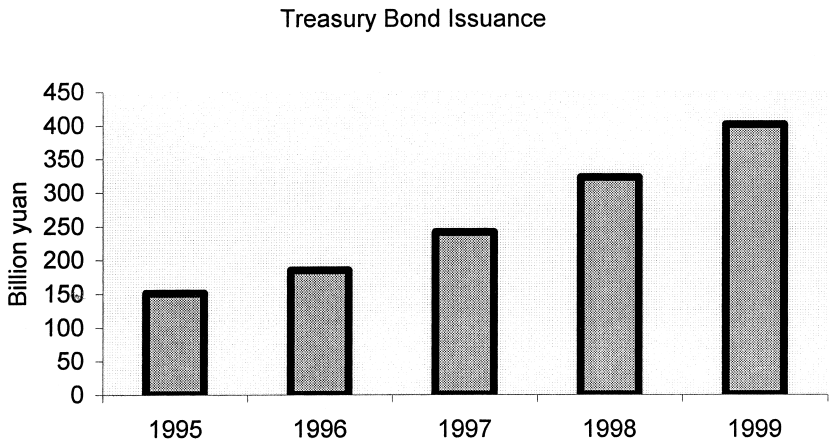
Although China has become a frequent issuer of treasury bonds, the development of the market has been handicapped by structural impediments. Three main obstacles are usually cited: interest rates are administered by fiat; market participants are not functionally specialized; and the custody and settlement infrastructure are not established.[8] Despite the handicaps, the government experimented with an auction system for selling its bonds in 1996, and it continued the experiment in the following year.[9] The experiment was quite successful, yet the government abandoned it in 1998 when it sold a number of its bonds in bearer certificate form, essentially non-tradable savings bonds. The most likely explanation for abandoning the market-based system is the government's desire to set interest rates. Since then auctions have been used intermittently. No yield curve yet exists in mature form for these instruments.

As the owner of the principal banking institutions in China, the

8. Gao Jian, *Zhongguo zhaiquan* (*Chinese Bonds*) (Beijing: Jingji kexue chubanshe, 1999), preface, p. 2.
9. *Ibid.* p. 16.

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Figure 3: **Treasury Bond Issuance**



Source:
Zhongguo tongji zhaiyao 2000.

government has used the lending power of the banks to provide cheap financing to its companies. This has led to a huge number of non-performing loans on the banks' balance sheets.

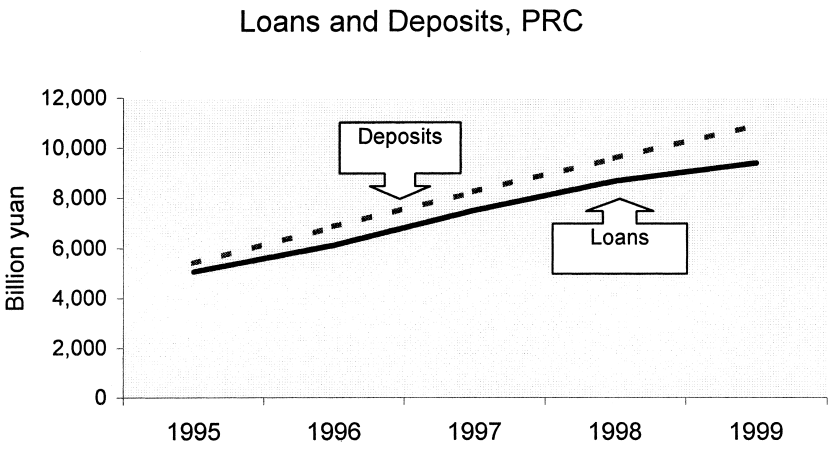
The Chinese government is not consistent in its approach to the banking sector. The People's Bank of China regularly issues pronouncements calling for the banks to build up their capital adequacy ratios. It also calls on them to improve prudential management by classifying and writing down unrecoverable loans. But the central bank has no power to dictate the accounting rules and taxation policies; the Ministry of Finance sets these. As the tax collector, the ministry's primary concern is to maximize its fiscal income. Accordingly, it imposes draconian taxes on the banking sector in the form of an 8 per cent business tax on gross revenues and a restriction on tax deductible write offs to less than 1 per cent of total loans. It taxes net income at the statutory rate of 33 per cent. In essence, a bank is unable to deduct its loan loss expense in excess of the tiny amount allowed by the ministry. The only way the banks can fund their tax liabilities is by dipping into their deposits and sending the money to the tax collector.

This system is another legacy of the planned-economy era when all banks were state owned and when the private sector was insignificant. But today not all banks are state owned, the government is talking about listing the shares of the state-owned banks on the public equity markets, and foreign banks are planning to enter in larger force pending China's accession to the WTO. The non-state-owned banks in China are still relatively small by comparison to the big four state-owned banks. But they compete for business in the market not only for loan customers but also for deposits and foreign exchange business.

To the extent that the big four can function with zero equity, under the

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Figure 4: **Loans and Deposits, PRC**



Source:
Zhongguo tongji zhaiyao 2000.

protective safety net afforded them by the government, the big banks' average cost of capital is extremely low (cost of equity = zero, cost of deposits is regulated). The non-state banks, however, must build their capital as a risk cushion, given that they are not protected by the government's safety net. When deposit rates are liberalized, these banks may have to pay higher rates than the big state banks in order to attract deposits. Thus their weighted average cost of capital will exceed that of the big four. The playing field is far from level. Meanwhile they must pay the expropriation taxes levied by the Ministry of Finance or risk being shut down.

Figure 4 shows the steady growth of loans and deposits in the economy over the period in question. The slope of the loan line is very different from the flat or declining slope of the graph of corporate bond issuance. Once it is observed that bank loans have grown steadily while bonds have not grown at all, it can be hypothesized that the central bank and the Ministry of Finance have retained a heavy reliance on administered lending through the banking system. The state is thus relieved of the burden of financing the extensive welfare activities of the SOEs so long as the bank-SOE nexus remains intact.

The life and casualty insurance markets have been partially open for several years. AIG, the American insurer founded in 1919, pioneered the foreign presence in this sector in 1992 when it opened a branch in Shanghai. For a number of years, AIG was extremely profitable. Recently, however, Chinese competitors have studied AIG's marketing techniques and poached personnel, with the result that they are claiming market share from AIG.

The total market for insurance has been growing in step with China's

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GDP performance. Table 1 indicates the scale of these markets in 1999, and include domestic as well as Sino-foreign joint venture institutions. These figures mean that China's insurance industry in 1999 generated about US$17 billion in premiums and payments of US$6 billion, on a policy base of US$8 trillion.

According to a survey by Zhang Da of the Jilin Branch of the People's Bank of China and Wang Yaping of North-east Normal University, as of the end of the third quarter of 1999 foreign banks had opened 155 branches in China, with total assets of US$31 billion.[10] About 47 per cent of these assets were in Shanghai, 22 per cent in the greater Guangdong area, 14 per cent in Shenzhen and the rest divided among other major cities. About 62 per cent of the lenders were Asia based banks.

China has already partially liberalized foreign bank entry to the local currency business, with some 32 foreign banks licensed to do *renminbi* business in Shanghai and Shenzhen.[11] At the end of March 2000, foreign banks held local currency loans of about 11.2 billion *yuan* (about US$1.4 billion or about 2 per cent market share) and foreign currency loans of about $21 billion (about 20 per cent market share). With total local currency assets of about 14.7 billion *yuan*, the foreign banks have only 5.4 billion *yuan* in deposits, far short of their loan levels. Thus the foreign banks have had to make up their funding shortfall by interbank borrowing, more expensive than deposits and incurring term mismatch risks.

Foreign banks in China today are very restricted in their activities. As noted, only a few banks have licences to do *renminbi* business, and the *renminbi* funding sources are tightly constrained. Writing jointly for the State Council Research Institute, Ai Hongde, Fan Lifu and Zhao Qingming acknowledged these limitations and said they had been created precisely to prevent the foreign banks in China from becoming too competitive and too profitable.[12] In order to compensate the foreign banks for the handicaps placed on them, the Chinese government set up waivers and reductions for three to five years for a number of important taxes.

China has licensed ten domestic fund managers to manage closed-end mutual funds traded on the Shanghai and Shenzhen stock markets. The authorities have been studying open-ended funds and plans are under way to open the market to them in 2001. The formation of the ten funds in 1998 was guided by the government's desire to promote investment in equities. As noted above, the government is the primary beneficiary of the proceeds from the listing of state-owned enterprises on

10. Zhang Da and Wang Yaping, "Jiaru WTO dui wo guo yinhangye de yingxiang ji qi duice" ("Impact and response on our country's banking industry by entering the WTO"), Guowuyuan fazhan yanjiu zhongxin xinxi wang (Guoyan), 15 November 2000.

11. Yin Qi, "Cong zai Hua waizi yinhang de fazhan kan ru shi dui guonei yinhangye de yingxiang" ("Evaluating the impact on domestic banking from the point of view of the development of foreign invested banks in China"), Guoyan, 11 November 2000.

12. Ai Hongde, Fan Lifu and Zhao Qingming, "Ru shi dui wo guo yinhangye de yingxiang" ("The impact of entering the WTO on our country's banking"), Guoyan, 23 November 2000.

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Table 1: **PRC Insurance Industry**

	Billion yuan		
	1999 premiums	*1999 payments*	*1999 policies in force*
Casualty insurance	52.7	27.9	13,868
Life insurance	87.8	22.8	52,774
Total	140.6	50.8	66,643

Note:
Figures do not sum because of rounding.
Source:
Zhongguo tongji zhaiyao 2000, p. 77.

the domestic stock markets. Its thinking in promoting mutual funds stems in part from its interest in maximizing its proceeds from future equity sales. Total capitalization of the 30 closed-end funds now in the market was reported at about 52.86 billion *yuan*, or roughly $6.3 billion.[13] The funds only buy and hold shares listed on the domestic A-share markets. In 2000 the government conducted a study of the funds' compliance with regulations and found a high degree of fraud. The report charged the fund managers with practically every deception in the book, from price manipulation to outright false reporting.[14]

China's Agreed WTO Framework for Financial Services: Protectionist

Commercial banking. When China enters the WTO, the accession terms[15] will permit foreign banks to open branches in China and to receive national treatment – after five years. From accession, foreign currency business will be unrestricted, but restrictions on local currency (*renminbi*) business will remain in place until the five years are up. During those five years, the foreign banks will be granted a licence to conduct business in four cities in the first year, and four more cities each additional year thereafter. In the first two years, foreign banks will be able to serve only foreign clients. Two years after accession, they will able to serve Chinese clients.

Non-bank financial. The Chinese agreed with the European Union to permit foreign non-banks to provide consumer credit in China for motor vehicle purchases. Thus distributors of such vehicles may set up finance companies to lend money to the purchasers of their products. This could potentially become a large business judging from the size of such institutions in the United States.

Asset management. China has imposed competitive restrictions on foreign asset management companies in order to protect the domestic players. During the first two years, foreigners will be able to do business as minority (one-third) partners with Chinese asset managers. This limitation will be expanded to a 49 per cent interest three years after accession to the WTO. The obvious intention is to prevent foreign players from controlling asset management companies on shore in China.

13. Richard McGregor, "Fears linger that China funds may damage your health," *Financial Times*, 5 September 2000, p. 22.

14. Ping Hu and Li Qing, "Jijin hei mu zhi hou ji – zhuangjia zhi bian" ("Behind the black curtain of the funds – a change in the speculator"), *Caijing zazhi*, October 2000, available on http://caijing.homeway.com.cn/1bi-html/caijing/monthly/200010/1336.html; Bruce Gilley, "China's dodgy funds," *Far Eastern Economic Review*, 14 December 2000, pp. 74–76; Richard McGregor, "Chinese fund managers 'made illicit deals in sauna meetings'," *Financial Times*, 18 October 2000, p. 1.

15. The White House, China Trade Relations Working Group, http://www.chinapntr.gov/industry; Daniel Arthur Laprès, "The EU-China WTO deal compared," *China Business Review*, July–August 2000. Available on http://www.chinabusinessreview.com/0007/lapres.html.

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Securities business: underwriting, brokerage. Foreign players will be allowed to hold one-third equity interests in securities companies in China after a three-year wait from the time of accession to WTO. The foreign competitors will thus be excluded from the market during the waiting period, and their reward for patience will be minority shares in on-shore companies. Once the three-year waiting period is over, the Sino-foreign joint ventures may underwrite all Chinese corporate securities, whether debt or equity, and government bonds.

The market in Chinese corporate shares is already open to foreign investors through the B share markets on the Shenzhen and Shanghai exchanges. These shares, settled in U.S. dollars, are issued by some, not all, of the A share companies. Foreign securities companies may act as brokers for these shares but not as primary market underwriters.

Insurance. The Chinese have agreed to implement prudential standards for approving insurance companies to operate in China. But they will impose a 50 per cent equity ceiling on foreign investment in life insurance in China. Although the European agreement claims the foreigners will be able to negotiate management control under the 50–50 restriction, the Chinese will retain the ability to block initiatives proposed by the foreigners, and vice versa. Non-life insurance will initially be subject to a 51 per cent equity ceiling on the foreign side, but that will be eliminated within two years after accession. Non-life is thus one of the few financial services that will be completely open to foreign entry.

Probable Strategies of Foreign Entrants

Companies who have dedicated resources to cracking open the Chinese market over the past five years have accumulated sunk costs. These companies will be most likely to go ahead in the securities and insurance areas regardless of short-time profitability forecasts. Some foreign fund managers will form joint ventures with Chinese counterparties. In a 50–50 joint venture, the foreign party has limited control over the strategy and products that the joint venture may pursue. Despite these drawbacks, some foreign companies will be willing to enter China's fund management market on Chinese terms just for the incremental revenues to be gleaned. However, one likely consequence of the enforced 50–50 (or worse, 49–51) joint venture structure will be the foreigners' lack of enthusiasm. Given the dilution in their returns, coupled with the difficulties of building businesses in China, they are likely to treat these ventures as low priority. Their willingness to assign talented staff to them will be modest; they may instead assign them token representatives, or try to manage them from abroad on a part-time basis.

In the securities business, foreigners will be kept out of the primary markets for a long time. The opening to them will be joint ventures in brokerage houses. As in the case of money management, foreign investment banks will be reluctant to bring in their name brands if they are

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forced to dilute the returns and share decision-making with Chinese partners.

Certainly the Chinese policy makers must realize that a consequence of requiring foreigners to invest through joint ventures is the dampening of their enthusiasm for the market. Perhaps they believe this will give Chinese competitors the breathing room to develop Chinese management and products that are capable of standing against the foreigners. What they perhaps fail to consider is the possibility that the protection afforded the Chinese participants will ensure that they do not become global competitors.

If China were to allow foreign companies to enter in their own names, with 100 per cent-owned subsidiaries, the foreigners would bring in their best practices from the advanced markets of the world. Chinese employees at these firms would quickly acquire that expertise, and many would leave to form their own competitor firms. The foreign competition would quickly lead to an upgrading in China's securities markets. The beneficiaries of this would be Chinese investors.

But China's WTO regime will not let this happen, and because of this China's financial system may languish like Japan's. Japan restrained foreign competition for many years. Its decade-long slump, still going on, is a consequence of its failure to open its financial services markets early enough to foreign competitors. Japan's banks are burdened by large overhangs of non-performing credits, whose resolution is impeded by inadequate institutions. Companies are facing large unfunded pension liabilities, and shareholder value destruction has been vast.

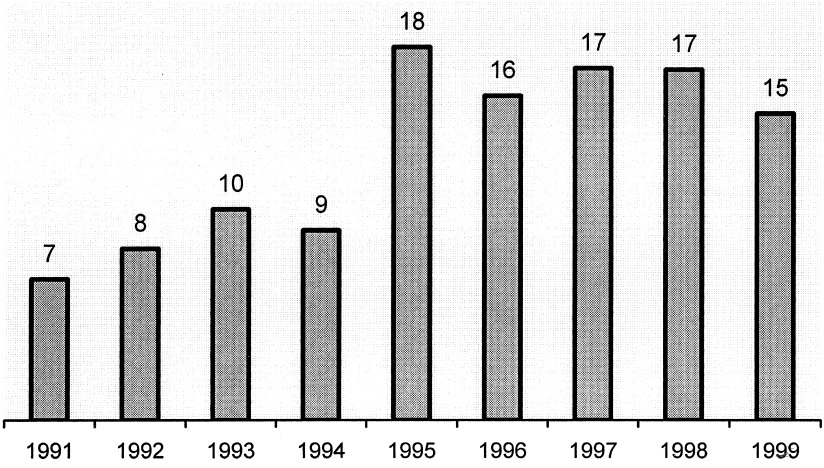
WTO Impact

Impact on foreign exchange controls. Nothing in the WTO accords *requires* China to make its currency convertible on the capital account. China has stated many times that its eventual objective is to make the currency fully convertible, but it has never announced a firm timetable for this change. The currency today is convertible for spot transactions by businesses and some individuals, but neither of these nor even government entities are permitted to book forward transactions in foreign currencies. While some creative hedging techniques are available, such as so-called non-deliverable forwards, these contracts provide very limited liquidity and tenor. And they are derivatives, not primary market transactions in the *renminbi* itself. The decision to change China's capital account rules lies purely within China's discretion. Thus it is entirely likely that China will adopt a wait-and-see attitude towards capital account convertibility once it has acceded to the WTO, and for many years thereafter.

Chinese and foreign observers have remarked on the phenomenon of capital flight from China. The "net errors and omissions" line in China's balance of payments reports reached a high plateau in 1995 and has stayed there (Figure 5). The conventional view is that it reflects capital flight. Dong Fu of the Dallas Federal Reserve Bank has shown that

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Figure 5: **China's BOP: Net Errors and Omissions (US$ Billion)**



Source:
IMF, *Balance of Payments Yearbook 1999, Part 1, Country Tables*, p. 183.

China's *net outflow* over the decade of the 1990s exceeded US$115 billion, or about 40 per cent of total foreign direct investment in China.[16] The Chinese government does not directly disclose these net outflows, but they can be derived from other figures that are disclosed. Dong supposes that the government does not directly disclose net outflows because they are an embarrassment.

China's "errors and omissions" in its balance of payments accounts represents leakage through the exchange control barriers. How much of the total in this category is due to legitimate capital export and how much is illegitimate is impossible to gauge. Like in Russia, capital exporters in China use trade-related know-how to funnel capital out of the country. These include external tolling (chiefly used with imports of raw materials), understatement of export prices and fictitious import contracts.[17]

The Chinese stepped up their surveillance of cross-border transactions in 1998–99 to crack down on illegitimate transactions. According to

16. Dong Fu, "Capital in and out of China," in Federal Reserve Bank of Dallas, *Southwest Economy*, March/April 2000, pp. 10–12.

17. L. Grigoryev and A. Kosarev, "Capital flight: scale and nature," International Monetary Fund, 24 February 2000. Available on http://www.imf.org. Wang Yuanlong, "Zhongguo ru shi hou yinhang shouyi chengben fenxi" ("A cost-benefit analysis of banks after China's entrance to the WTO"), Zhongguo renmin daxue Zhongguo caizheng jinrong zhengce yanjiu zhongxin, on http://ww.frc.com.cn/hot/wto/bank.htm. See also X. L. Ding, "Systemic irregularity and spontaneous property transformation in the Chinese financial system," *The China Quarterly*, No. 163 (September 2000), pp. 633–654. Tao Xiang, "WTO gei jinrongye dailai shenme?" ("What does the WTO bring to the finance industry?"), *Zhongguo qiye bao* (*China Enterprise News*), posted on 6 March 2000, on http://ww.fiec.com/forum/dit/HY/mess/16.html.

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reports, they reviewed 51,900 international payments made in the first half of 1998 and determined that 13,900 or about 27 per cent could not prove their legitimacy. The same report indicated that some $11.9 billion had fled China illegally in the first half of 1998.[18] To deal with increasing abuses of the system, the Chinese government has put in place more rigorous reviews of transactions, better computer systems and networks, and tougher penalties (including the death penalty). These measures have yielded some successes, but the administrative costs, the additional burdens on legitimate players and the reduction in efficiency of capital allocation are all significant invisible costs.[19]

The non-convertibility of the currency on the capital account creates incentives for players to go around the restrictions. As investments inside China by foreigners and outside China by Chinese grow, a pattern that will certainly continue after China's accession to the WTO, the need to hedge the long-term exposures that these investments entail will grow accordingly. If legitimate means are not readily available, players will be strongly tempted to resort to other means to manage their risks.

The Research Institute of the State Council has concluded that China must change the way in which it monitors and regulates foreign exchange transactions. In the current system virtually all transactions must be examined for approval, a "universal auditing" procedure (*pubian hecha*). Under the increased volumes of transactions that can be expected after China's accession to the WTO, a new system based on "key points auditing" (*zhongdian hecha*) must become the approach, in which the authorities focus on the transactions of the big corporations or other players whose moves can affect the market.[20]

Impact on the banks. Many analysts in China comment that unrestricted foreign banks would lure depositors away from the Chinese banks. They claim that the foreign banks will do so because of their superior financial ratings and their better service. The fear is that depositors might run on the Chinese banks to withdraw their funds. Professor Justin Yifu Lin at Peking University shares these fears, but he says that a massive shift to foreign banks is unlikely because of the new rule that requires depositors to disclose their real names.[21] The presumption is that most wealthy depositors to date have made deposits under fictitious names to hide their funds, often ill gotten, from the authorities.

Xu Dianqing expresses similar fears about possible runs on the Chinese banks. He imagines that with 28 per cent non-performing loans officially

18. Akira Ariyoshi, Karl Habermeier, Bernard Laurens, İnci Ötker-Robe, Jorge Iván Canales-Kriljenko and Andrei Kirilenko, "Capital controls: country experiences with their use and liberalization," International Monetary Fund, Occasional Paper No. 190, 17 May 2000.

19. *Ibid.* p. 30.

20. Wen Jiandong, "China's WTO entry and revision of foreign exchange control regulations, rules," *China Law*, August 2000, pp. 65–69; and the Chinese version "Jiaru WTO yu Zhongguo waihui guanli fagui di tiaozheng," *Zhongguo falü*, August 2000, pp. 11–13.

21. Justin Yifu Lin, "China's accession to WTO: impacts on agriculture and financial sector," Peking University China Center for Economic Research, Working Paper Series, number E2000009, 3 November 2000.

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acknowledged at the four big banks, they will not be able to maintain their credit standing once the foreign banks enter China in force.[22] He worries about the sensitivity of foreign currency deposits held by the Chinese banks, and argues that since most of these foreign currency deposits are loaned out on long-term contracts, the withdrawal of only $2 billion, or less than 20 per cent of all foreign currency deposits, from the Chinese banks could trigger a solvency crisis.[23]

The two scholars' fears are groundless for the simple reason that foreign banks' appetite for deposits will be limited. They will of course welcome additional *renminbi* deposits above the tiny amount they now enjoy, if only to enable them more cheaply to fund their lending efforts in local currency. But deposits have to be invested in assets like loans, and the foreign banks will be extremely wary of building large loan books in China. Similarly, the foreign banks will be cautious in bringing capital into their China branches. It is not out of the question that the foreign banks will pay lower interest on deposits than the Chinese banks, if interest rates are liberalized, to alleviate their concerns about profitability, capital and risk. For these reasons, their China-based balance sheets will be limited in size.

The real challenge of the foreign banks will lie in the areas of capital adequacy and profitability. Having no system for measuring return on capital, the Chinese banks price investments (loans) with little regard to risk and return. With loan spreads controlled by the government and the banks devoid of capital, the domestic bankers have no capital charge to include in their lending spreads. Hence they undercharge for the credit that they provide to industry and do not properly allocate capital according to efficiency criteria. The foreign banks, by contrast, have honed these skills over many years and have paid a great deal of tuition in terms of lost revenues and capital.

Chinese banks measure their capital adequacy today according to Chinese accounting standards, by which vast amounts of non-performing loans are carried at par with no reserves for credit losses. These banks greatly over-state their capital. Nominal capital adequacy ratios of the Chinese banks range from 8 to 15 per cent according to Chinese measures, but if measured according to international accounting standards or U.S. GAAP, their capital ratios would be close to zero or even negative.

Western banks are much better capitalized. The average capital adequacy ratio among the private banks in the OECD is about 11 per cent, well above the minimum 8 per cent ratio that is specified by the Bank for International Settlements. As foreign banks begin to distribute information about their financial positions, and as Chinese analysts began to make comparisons with the Chinese banks, depositors in China's state-

22. Xu Dianqing, "WTO yu guoyou jinrong tizhi gaige WTO," ("The WTO and the reform of the state-owned financial system"), Peking University China Center for Economic Research, Working Paper Series, number C2000014, October 2000, p. 3.
23. *Ibid.* p. 4.

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owned banks may grow concerned. If they come to believe that the sovereign guarantee cannot be upheld, it is not clear what their reactions may be.

The starting point in much Chinese analysis of the challenge to China's big four banks posed by the entry of foreign banks is the fear of shrinkage. The logic goes: if the foreign banks provide better service, they will take business away from the Chinese banks. The Chinese banks will therefore have to shrink in size, in terms of both assets and employees. This will lead to a financial crisis. A good example of this type of analysis is an article by Wu Min of Dongbei Caijing University.[24] Wu's concern about the employment issue is easy to understand. The Chinese banks are already overstaffed. If the foreign banks can take business with smaller staffs, the Chinese banks will have to lay off people to maintain profitability. Wu's implicit zero-sum assumption is that if the foreign banks win business, the Chinese banks must lose it.

The official view of the government, echoed by Wu, is that the big banks can maintain their solvency so long as they continue to grow, where growth is defined as increases in deposits and loans. "A rising tide lifts all boats," and this describes the solvency of the Chinese banks. Their ample liquidity today is generated by waves of deposits coming in through their tellers' windows. Today the banks have no problem meeting their obligations. If the tide stops rising or even starts to fall, it is not clear how long the banks will be able to meet their obligations – including their onerous tax obligations. The deep fear therefore is that foreign competition will lead to a bank solvency problem. In a case of insolvency, the government would face enormous problems, not the least of which would be the inability of the banks to pay their taxes.

Recent scholarship suggests that Wu Min is right to fear declining profitability of domestic banks after entry of foreign competitors. One analysis of 80 countries over the period 1988–95 showed that profitability of domestic banking institutions went down as a result of foreign entrants. A reason for that is simply that when foreign banks are granted entry, the indigenous banks are forced (because of new regulations, embarrassment or other reasons) to increase their provisions for bad loans. Naturally this hurts profitability.

The other side of the coin, however, is that foreign entry leads to higher efficiency in the domestic banking industry.[25] Research also suggests that foreign bank entry to an emerging market is a stabilizing factor rather than the opposite. The likelihood of a banking crisis in an emerging market is apparently reduced when foreign banks acquire a

24. Wu Min, "Wo guo shangye yinhang ru shi hou mianlin de xingshi ji duice," ("Form and policies faced by our country's banks after entrance to the WTO"), Guoyan, 19 and 23 October 2000.

25. Stijn Claessens, Asli Demirgüç-Kunt and Harry Huizinga, "How does foreign entry affect the domestic banking market?" May 1998. Available on http://www.worldbank.org/publications.

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share of that market.[26] To some extent foreign bank presence deters capital flight, since depositors can place their funds in foreign banks rather than move it offshore. Internal capital flight, the shift of deposits from domestic institutions to foreign, can occur and did in the case of Korea between 1997 and 1998.[27] But this research is not conclusive.

Wu Min is at the same time highly critical of China's domestic banks. He says they are guilty of deteriorating transparency and false reporting, matters that he fears will induce a systemic banking crisis unless corrected. Wu attacks the "separate industry" regulatory environment in China. While he concedes that it makes risk management easier, "separate industry" regulation and management in fact drastically narrow the business scope of financial institutions. Since the big four banks' principal clients are the state-owned enterprises, whose financial condition is notoriously weak, the banks' narrow business scope exposes them to a high degree of concentration risk.

Wu's fear is that China's adverse financial regulatory environment will worsen once it accedes to the WTO. Chinese financial institutions, weakened by the regulatory framework, will be uncompetitive in the new post-WTO environment. Most troubling to Wu is the separation of trust activities from banking activities. Because of this separation, China's trust business, the business of managing other people's money, is incredibly weak. As soon as the foreign competitors come in, the Chinese players will face "death by drowning" (*mie ding zhi zai*).

Wu also mentions other competitive disadvantages of the Chinese banks, all of which are a product of China's national strategies. For example, compensation systems in China do not link performance and pay, and compensation is generally egalitarian. Foreign banks can pay high salaries to recruit talented Chinese to work for them, whereas the Chinese banks are unable to pay such salaries. This is a legacy of China's famous "eating out of one pot" culture from the pre-Reform days. Chinese banks do not properly manage their proprietary businesses, nor do they write down bad loans sufficiently. Wu points out that the regulators are to blame for this, since they impose an immense amount of restriction on write-downs. For all these reasons, the foreign banks will have the upper hand in competition with the Chinese banks.

Ge Zhaoqiang, writing for the State Council Research Department, gave a list of the things the banks must do in order to meet the post-WTO foreign challenge.[28] His list of action points makes good sense, but none of them can succeed unless the owners, directors and management of the banks are able to optimize their risk and return calculation and to measure (and retain) capital. His list is useful for reference:

26. Donald J. Mathieson and Garry J. Schinasi, *International Capital Markets: Developments, Prospects, and Key Policy Issues*, Washington, International Monetary Fund, 2000, ch. 6, "The role of foreign banks in emerging markets," pp. 152–182, p. 168.

27. *Ibid.* p. 170.

28. Ge Zhaoqiang, "Jiaru WTO yu wo guo shangye yinhang gaige celüe xuanze" ("Joining the WTO and the strategic choices for reforming our country's commercial banks"), Guoyan, 11 November 2000.

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- Improve the payment system, service quality and efficiency
- Diversify the scope of business activities
- Redesign banking ownership and management
- Pay the needed costs in terms of friction, application and time in order to make these changes
- Maintain the reputation and credibility of the banking system
- Adjust the compensation system to retain good people

Nowhere does Ge address the building of capital. This is perhaps because under the current system, it is virtually impossible to build capital. His third bullet point addresses the ownership system, but it provides no concrete suggestions.

Tao Dan at the Institute of Finance of Shanghai Caijing University has pointed out critical flaws in China's regulatory model.[29] According to him, the principal regulatory objective of China's banking regulators is to stabilize the currency. This means that in practice, the regulatory system primarily focuses on constraining banking activities at the expense of attention to capital management.

Tao compares the bank-rating model used in the United Stares known as CAMEL against the rating system adopted by the People's Bank of China. The "C" in the CAMEL system stands for capital, and it accounts for 20 per cent of the rating of a bank.[30] In the Chinese model, however, capital accounts for a mere 5 per cent of the rating. In the Chinese rating system the top priority is compliance with business management regulations, which accounts for 25 per cent of the rating. Compliance is not even a specific criterion in the CAMEL system, although it is certainly embedded in the "M," management. Similarly, the Chinese scaling system assigns only a 10 per cent weighting to earnings quality.

If China's regulatory model is wanting, so also is its ownership model. The government is a bad owner because it does not perform the duties that an owner of productive assets should. It does not exercise prudence in the investment of capital. The government justifies its onerous taxation system, which withdraws precious capital out of the financial institutions, by saying that if it did not tax in the way it does, the government-owned banks would pay no tax. Instead, they would pay all their "profits" in the form of compensation to themselves.

This is a failure of ownership. The rationale behind China's ongoing "corporatization" process is one of "non-privatization." The government is *not* privatizing its corporations when it sells minority shares on the stock exchange, for the government retains control. It claims that it is a responsible owner. But at the same time it admits that without draconian taxation, it would collect no tax at all. In other words, the "owner" does not impose discipline on the companies it "owns."

29. Tao Dan, "Jiaru shijie maoyi zuzhi dui zhongguo de yinhang jian'guan tixi de tiaozhan" ("The challenge to China's banking regulatory system posed by the entrance to the WTO"), Guoyan, 24 October 2000.

30. The others are A for Asset quality, M for Management quality, E for Earnings quality, and L for Liquidity quality. Each counts for 20% of the rating.

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In a dictat system like China's, banks cannot finance their operations without specific approval from the central bank, the Ministry of Finance, the securities regulators and the State Council. If they want to write off their bad loans and reduce their taxable income in the interest of prudential management, they cannot do so without approval from the same list of regulators. Nor are they permitted to issue subordinated debt to enhance their capital adequacy ratios.

Impact on the securities markets. As noted above, the corporate bond market in China has been suppressed. Instead, the bank and securities markets have absorbed the vast portion of financing needs. This probably reflects the regime's desire to keep national savings under its control, within the state-controlled banking system.

Yet as China becomes increasingly integrated with the world economy, sophisticated foreign companies will set up treasury operations in China to fund their activities there. These companies will demand cost-efficient direct finance vehicles to raise capital in local currency. As these demands grow more strident, the regime will be pressured to relax the informal restrictions on this market. The corporate bond thenceforth will grow rapidly.

As the direct finance field grows, credit-worthy Chinese firms will see the benefits of direct finance, and they will demand the ability to raise capital in the markets at market-determined interest rates. This will lead to a disintermediation of the banking system and a loss of power by the state. In the long term the establishment of a mature balance between direct finance (the capital markets) and indirect finance (the banking market) will be good for China. It will create competition between the two sectors, and it will transfer risk from the banking system to the shoulders of investors. This will alleviate the country's excessive concentration of credit risk in the banking system, which in turn strains the resources of the government that must provide credible last-resort support to the banks in the event of a financial crisis.

Changes such as these will take years to be realized, and the government will resist acceleration of the process for reasons already discussed. The costs of delay to China will be evident in the continuation of excess risk concentration in the banking system and the prolongation of sub-par returns on capital.

Eventual Dismantling of Financial Barriers

Already there have been extensive discussions among government-sponsored think-tanks in China about privatization, including the re-establishment of private property rights. These have surfaced most famously in the injection of language to the Chinese Constitution granting legitimacy to the private economy in the context of state ownership. The Constitution has but dubious legal bearing in a court of law in China, but its role as a forward-looking aspirational document is significant. It sets the ideological direction of the regime's leaders and planners. Hence we

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can expect continued liberalization of property concepts as China's reform process progresses. As to when the regime will make the required paradigm shift that will propel evolution of the private tax-paying economy, no one can predict for sure.

China's natural reluctance to allow excess foreign competition into the financial sector is understandable, but if the leaders overcame their reluctance, benefits would accrue to China's savers. Protected industries by definition remain weak, and a protected financial sector only means the prolonged under-utilization of the nation's financial resources.

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