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China's WTO Accession and Its Impact on China's Financial System

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China joined the WTO on December 11th, 2001. It was 15 years after its application to the GATT in 1986. The accession to the WTO is a bold step forward for China to reform its economy. The accession will affect not only the real sector, but also the financial sector. China's financial industry will face enormous challenges and successful reform would have a profound effect on the future of China's economy. It would contribute to a more sustainable growth of the country and would have a very positive impact on the other economies in Asia and other regions.

In this paper I first describe the changes that WTO entry brings to China. And I will review the impact on China's financial industry, especially the banking sector, the risks involved in the process and how to deal with these risks.

1. The Accession of China to the WTO and its impact

(1) The accession of China to the WTO

China started its negotiations to join the WTO in 1986 and there was a long process before reaching the final agreement. In July 1999, China and Japan reached a bilateral agreement. China and the United States reached an agreement in November 1999. In May 2000 the EU and China finally came to an agreement.

Immediately after the formal signing ceremony of November 11, 2001, China notified the WTO that it had ratified the membership terms, paving the way for the world's most populous nation and its fourth biggest trader (counting the EU as one trader) to become the WTO's 143rd member on December 11.

China's WTO commitment represents the consolidation of the 37 bilateral agreements with the United States, the European Union and other WTO members. China's market access commitments include the elimination or reduction of tariff rates and the relaxation of various non-tariff restrictions, including the removal of barriers to imports of agricultural products, and reduction in quotas on trade in services.[1]

(a) Tariff rate reduction and reduction of non-tariff barriers

When China implements these commitments, China's average tariff rate will go down from 18.9% to 15% for agricultural products and from 14.8% to 8.9% for industrial goods. Among industrial goods the tariff rate on IT products will become zero from 13.3% and on automobiles from 80-100% to 25%. Table 1 shows the tariff reductions after China's accession to the WTO.

Table 1 Tariff Reduction after China's Accession to the WTO

Sector or selected sub-sector		Level in2001 (%)	Tariff level after WTO accession (%)	Difference between 2001 applied and agreed rates (%)
Agriculture: average		18.9	15 (1.1. 2005)	3.9
Industrial products: average		14.8	8.9 (1.1. 2005)	5.9
	IT products	13.3	0 (1.1. 2005)	13.3
	Automobiles	80-100	25 (1.7. 2006)	55-75
	Textiles and apparel	25.4	11.7 (1.1. 2005)	13.7
	Steel	10.6	8.1 (1.1. 2004)	2.5

Source: OECD [2002]

China's commitment to concessions in the trade in goods is evaluated as comparable to those of the major ASEAN countries.[2] For example, the final tariff level of industrial products, 8.9 percent, is higher than the current rates of 0 per cent of Singapore or 6.9 per cent of the Philippine, but lower than those of Indonesia (8.8 per cent), Malaysia (10 per cent) or Thailand (15.8 per cent).

(b) Concessions relating to financial services

China's commitments are not limited to the goods trade. China has made a broad range of commitments to open up its service sector to foreign investment and participation gradually after its entry into the WTO. Developing the service sector is very important from China's viewpoint, because this sector is accounting for only 35 per cent of its gross domestic product currently and employment in this sector is also low. China needs to develop its service sector in order to offer more employment opportunities for its population.

China's commitments cover financial services, distribution, business,

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[1] OECD[2002] p. 749

[2] Japan team [2002] p. 234

communication, tourism and travel related services, and other areas.

In the financial industry the main commitments are summarized in the attached table in the Annex.

Since accession foreign banks are permitted to provide foreign ervices and there are no geographical restrictions on such operations. Concerning the business conducted in the renminbi, restrictions on geographic coverage will be gradually removed and foreign banks will be free to offer the renminbi services all over China in five years. In two years foreign banks will be permitted to provide the renminbi services to Chinese corporate clients and they will be permitted to provide the renminbi services to Chinese individuals in five years.

Foreign financial institutions with total assets of more than US 10 billion dollars are eligible to establish a subsidiary or a financial company in China. Foreign financial institutions with total assets of more than US 20 billion dollars are eligible to establish branches in China.

Foreign non-bank financial institutions were permitted to provide auto financing upon China's accession to the WTO.

If China observed this commitment, in five years foreign banks would theoretically be able to offer services to their clients without disadvantage compared to Chinese banks. However, very recently China imposed a limit on inter-bank borrowing by banks. According to this restriction, banks can borrow from the inter-bank market only up to 40 per cent of their renminbi debt. Such a rule would restrict foreign banks' activities, because foreign banks could otherwise fund their loans by utilizing money market funding. If such restrictions should be imposed further, fair competition between Chinese and foreign banks would be difficult to achieve.

The capital market will be opened to foreign competition in a very restricted way. Foreign companies can establish joint ventures with Chinese companies for fund management operations. However, the maximum participation of foreign companies is limited to 33% upon accession to the WTO and 49 % three years after accession. Within three years after accession, foreign investors will be able to form a joint venture with Chinese companies, with a maximum equity stake of one third to engage (without Chinese intermediary) in the underwriting of all types of shares as well as government and corporate bonds, to engage in the trading of B and H-shares and bonds, and to participate in the launching of investment funds.

(c) Government policies, regulations and administrative systems

In addition to the commitment in tariff, non-tariff and services industries, China is obliged to overhaul government policies, regulations and administrative systems. Joining the WTO requires a new member to run its economic policy according to the "rule of law" instead of the long tradition of the "rule of men" and China will have to change its government policies, regulations and administrative systems on this principle. It will make China more transparent and accessible to foreign companies.[3]

For this purpose, China started to "clean up" its existing legal system. The ministries have reviewed many laws and regulations and decided to repeal or amend them. The National People's Congress completed this process[4] in July 2001 so as to make them fully compliant with the WTO rules.

(2) The impact of China's accession

China's accession to the WTO will bring about various changes in the country. The lowering of tariffs and the abolition of quotas will bring more competition to the domestic market. The increased presence of foreign companies in the service sectors will bring more competitive and customer-oriented services to markets. The reforms on regulations will make government policies more transparent and create a level playing field for market participants.

The accession to the WTO, therefore, will have a huge impact on China's economy, and Chinese institutions will face tremendous changes ahead.

(a) Impact on industries

When China's commitments on tariffs and import quotas are implemented, China will have moved toward a regime based on tariffs. It will be phasing out quotas, licenses and other non-trade barriers. Industries will face a different level of competition, depending on their comparative advantages and on the speed of domestic demand growth.

In general, the textile sector will benefit the most, because a labor intensive industry like apparel has a comparative advantage in China. In contrast, capital-intensive industries like automobiles, petroleum, electronics, machinery and ferrous metals could lose, as protection for these sectors will gradually be phased out.

The number of auto producers in China is too large by international standards. China had 115 automobile manufacturers in 1999. The central government planned to restructure and reorganize these manufacturers. But it has been very difficult for the

[3] Yongtu [2003] p. 27
[4] Law on Chinese Foreign Cooperative Law, Law on Foreign Capital Enterprises, Customs Law, Patents Law, Trademarks Law and Copyright Law

government to streamline the industry due to the resistance of the relevant regions.

In some industries China already has companies which are able to compete very well internationally, like Haier, the largest manufacturer of refrigerators and TV sets. It formed a joint venture with Japan's Sanyo to sell Haier's products in Japan.

Therefore the picture which will emerge in 2010 will be very different from and more complicated than what we can suppose now. One thing that is very clear is that in this evolving process many state-owned enterprises (SOEs) will be forced to go out of business and new small and medium enterprises (SMEs) will be successful in getting new markets. Foreign players will also play very important roles to reform markets in China.

Consequently, China's financial institutions will face the indirect impact of WTO entry. According to Hagiwara, who studied the Chinese industries one year after accession,[5] they seem to be performing better than anticipated before the entry. One example is the electronics industry. Another example is the automobile industry. In spite of the reduced import tax rate, the electronics industry is competing well with foreign companies and the auto industry is also expanding very quickly. The sales of automobiles in China increased by 28.4 per cent to 438 thousand cars in the first half of 2002.

This expansion was supported by lower prices due to reduction in import tariff rates and the price cuts by domestic manufacturers that followed. The supporting industries of automobile production are also growing fast in China and there appears even to be a possibility that China might become the export base for foreign car companies in the future.

However, Chinese industries will face a real challenge later on when tariff rates will be further lowered and the economy more open to the world than today. This will promote a reform process within China. There is high possibility that uncompetitive companies will be forced out from the markets and the financial industries will feel the pain.

(b) Effect on China's financial industry

In addition to the effect coming from the real sector, China's financial system also faces direct challenges within the sector, because it will face tough competition from foreign institutions.

According to China's agreement with the WTO, it is obliged to open up its financial markets to foreign firms within five years from accession. This will create stiff

[5] Hagiwara [2002]

competition for China's financial industry. Usually foreign firms have a strong competitive edge in the fields of investment banking, like securitization, M&A and project finance. The investment banking business will not be opened directly to foreign banks but they are permitted to form joint ventures with Chinese entities and participate in the capital market activities.

Most of the foreign banks will hesitate to participate in the retail market and to commit large amounts of capital as we have seen in other countries. In the retail banking business, the Chinese banks will have a competitive edge because of their wide branch networks and close contacts with local companies and individual customers. To build up a wide commercial banking network and to cultivate bank-client relationships are very time consuming and foreign banks are usually not interested in such an investment.

However, the question is whether commercial banking will be a profitable business even for the Chinese banks. Especially when interest rate liberalization takes place and interest margins narrow in the future. Interest rate liberalization is a necessary step for further development of China's banking system, but can also hurt the system. I will discuss this later in this paper.

Foreign banks will concentrate more on large scale corporate business, like loans to multinationals, foreign exchange, trade finance, custody service, and cash management service, so Chinese banks will face stiff competition from foreign banks mainly in these areas.

2. Development of China's financial industry and current problems

(1) History of China's financial industry

In order to understand how important and difficult it is for Chinese banks to face these challenges and to reform themselves, it is useful to look at the history of China's banking industry.

(a) Mono-bank system

At the outset of economic reforms in 1978, there were only three banks in China: The People's Bank of China (PBOC), the Bank of China (BOC) and the People's Construction Bank of China (PCBC)[6]. The PBOC acted both as a central bank and as a commercial bank. The BOC was a monopoly bank responsible for international financial

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[6] Wei [1999]

transactions. The PCBC transferred budget funds and distributed them to the SOEs for fixed asset investment. These three banks constituted a mono-bank system and they worked more like administrative agents than real banks. The function of this mono-bank system was totally different from the usual banking system of developed countries. The mono-bank worked as a kind of budget distribution system.

(b) Establishment of four commercial banks.

In 1978 China began to reform its economic system and open the door to the world. The economy started to be decentralized and China began to reform its financial sector to support its overall economic reform and development.

China transformed the budget grants into bank credits and created the framework for a two-tier banking system. PBOC was made the central bank and was to perform only the functions of a central bank. In 1995 The Central Bank Law was introduced to make the PBOC a modern central bank. In 1979 its commercial banking business started to be taken over by the newly created Industrial and Commercial Bank of China (ICBC). In the same year the Agricultural Bank of China (ABC) was established for rural finance.

Now the commercial banking institutions in China consist of four types of credit institutions; state-owned commercial banks (SOCBs), the newly established commercial banks, the city cooperatives banks, and the credit cooperatives.

The four SOCBs are the Agricultural Bank of China (ABC), the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC) and the China Construction Bank (CCB).

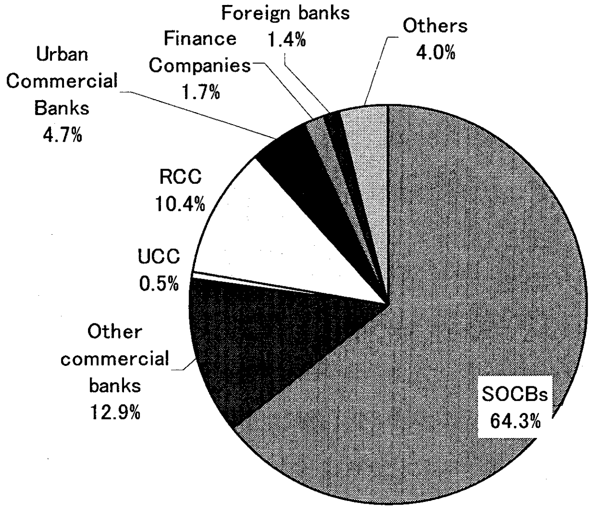
These four state-owned commercial banks are dominant in China's banking industry.

In 1984 China extended economic reform to the industrial and commercial sectors. Non-state enterprises started to compete with the SOEs. And to meet the demand for funds for small scale financing of such private companies, rural credit cooperatives (RCCs) under the supervision of ABC and urban credit cooperatives (UCCs) were created in 1986 under the supervision of ICBC.

Chart 1 shows deposit shares of these banking institutions. The major part of banking activity is still dominated by four SOCBs.

The government also established three policy banks in 1994. They are the State Development Bank of China, the Export and Import Bank of China and the Agricultural Development Bank of China. These policy banks have contributed to freeing commercial banks from political decision-making and enabled them to make decisions based on

Figure 1 Asset Share of Banks as of June 2002



Source: *The People's Bank of China Quarterly Statistical Bulletin*

economic grounds.

From 1995, Urban Cooperative Banks started to be established based on the UCCs, and RCCs started to be transformed into Rural Cooperative Banks.

Since 1986, foreign financial institutions have been allowed to establish branches and joint ventures with Chinese financial institutions.

(2) Financial assets of China's households and entities

The table shows the flow of funds in China in the year 2000. According to this, 80 per cent of funds went to non-financial corporations via the banking system, 19 per cent through the equity market and one per cent through the bond market. The bond market is a very marginal market in China. Most funds flow through the banking system.

Very large part of this flow through the banking system goes through the four state-owned commercial banks.

Table 2 Flow of Funds 2000

(Unit: 100million RMB)

	Household		Non-financial corporations		General Government		Financial Institutions		The rest of the world	
	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources	Uses	Sources
Net Financial Investment	7898		-5269		-1000		67		-1696	
Deposits	6610		7767		2054		538	16425	-4	538
Loans		2972		9317		263	13969	-307	-198	1526
Securities	2223			2200	19	3132	3335	818	572	
Bonds	696			100		3132	3335	818		
Government and public bonds	770					3132	2343			
Share	1527			2100						
Foreign Direct investment			76	3179						

Note: This table is covering only a part of the complete funds flow.
Source: *The People's Bank of China Quarterly Statistical Bulletin*

(3) Current problems of China's financial industry

As we have observed in the previous section, the major part of China's financial assets is still dominated by banks, especially by the four SOCBs. The necessary reforms for China's financial system are many-sided. However, I will concentrate on the problems of non-performing loans (NPLs), corporate governance of banks, interest rate liberalization, SME access to bank lending and the role of foreign banks. These problems are closely related to other topics like bank supervision, regulation, accounting and strengthening of capital markets. However, I would like to limit the discussion here to the four points. These four points are essential for immediate banking reform in China.

(a) Non-performing loans

NPLs are still a serious problem for China. As the history of China's financial system shows, there was no clear separation between the role of different banks and there was no clear division of labor among the central bank, commercial banks and policy banks. These banking organizations and the central planning system caused NPLs to accumulate.

The Chinese authority started to tackle these deep rooted problem in the 90s. In 1999 the four commercial banks each set up an AMC to which they transferred bad loans. The four AMCs are Cinda, Great Wall, Orient and Huarong. Each AMC purchases bad loans from each bank at face value and funds the purchase through the issue of bonds implicitly backed by the Ministry of Finance.

Table 3 Asset Management Companies of Four SOCBs

Four State Owned Commercial Banks	CCB	ABC	BOC	ICBC	Total
Total Asset (as of end 2001, RMB hundred million)	27,650	25,280	25,966	43,181	122,077
Ratio of NPL (as of end 2001, %)	19.35	n.a.	27.51	29.8	25.37
Asset Management Company	Cinda	Great Wall	Orient	Huarong	
Date of establishment	1999/4/20	1999/10/18	1999/10/15	1999/10/19	
Source of funds (RMB hundered million)					
Capital (from Ministry of Finance)	100	100	100	100	400
Lending by PBOC	0	3,458	1,074	947	5,479
Issue of debentures underwritten by group banks)	3,730	0	1,600	3,130	8,460
Trasfer amount to AMC (RMB hundred million)	3,730	3,458	2,674	4,077	13,939
NPL disposition amount (until 2002/9) (A)	702	838	340	443	2,323
Recovery amount (B)	280	160	192	214	846
Recovery ratio (B/A, %)	39.9	19.1	56.5	48.3	36.4
Cash recovery (C)	216	77	86	146	525
Cash recovery ratio (C/A、%)	30.8	9.2	25.3	33.0	22.6
Debt equity swap					
Number of corporations	168	21	65	333	587
Amount (RMB hundred million)	1,545	125	639	1,100	3,409

Source: Hagiwara (2002)

The recovery of assets is made through debt equity swap, sales of assets or auction. When an AMC makes a loss because of lower recovery rate, then the state must cover the loss incurred. Table 3 shows how the four AMCs have disposed NPLs transferred from the SOCBs.

Even after the transfer of NPL assets to the AMCs in 1999, total NPLs in SOCB assets still amount to RMB 1.8 trillion and the percentage share of NPLs is 25.4%. The government directed the four commercial banks to decrease their NPLs by 2 to 3 % yearly. Very recently the PBOC reported that the NPLs of Chinese banks decreased by RMB 95.1 billion or 4.5% of the total assets in the period from the end of 2001 to the end of 2002.[7]

There seems to be wide expectation that the "grow-out strategy" is feasible. But the grow-out strategy should be reviewed very carefully both at the level of the micro- and macro-economy.

On the micro basis, the SOCBs moved part of their NPLs to the AMCs and SOCBs are expected to reduce their NPLs every year from their annual profit and to solve the NPL problem eventually. In a recent speech at the ABDI in Tokyo, Mr. Liu, chairman and president of BOC, expressed his hope to grow-out of problem loans and the vice president of BOC also expressed the same expectation in his speech[8]. However, this strategy is causing serious problems. The four SOCBs are ordered to reduce their debt

[7] *Nikkei*, January 15, 2003
[8] IIMA [2003]

by 2-3 % every year. Because of the low capital ratio and the concern for accumulating bad debts, banks tend to reduce lending to private enterprises and to purchase risk free government bonds, causing a kind of credit crunch.[9]

Table 4 Illustrative Summary of Costs of Financial System Clean Up

(based on data for end-2000)

Amount (bn RMB unless otherwise indicated)	Total	All banks	SOCB	JS and City	Co-operatives
Assets	13 745	11 672	10 144	2 110	2073
Loans to non-financial institutions[1]	10 038	8 452	7 606	1 171	
Estimated NPL	4 164	3 371	3 202	234	793
Per cent of all loans (%)[2]	41	40	42	20	50
NPL to be assumed by government	3 160	2 526	2 441	114	634
Capital injections	65	33		33	32
Total gross cost/GDP (%)	36	29	27	3	7
Total cost net of recovery/GDP (%)	29	23	22	1	6

1 Excluding loans to the government and to other financial institutions.
2 Figures for SOCBs include the 1.3 trillion RMB transferred to asset management companies in2000 and assume an NPL rate on loans remaining with SOCBs of 25 per cent.
Source: OECD

Table 5 Range of Possible Costs of Financial System Clean Up

(Per cent of GDP)

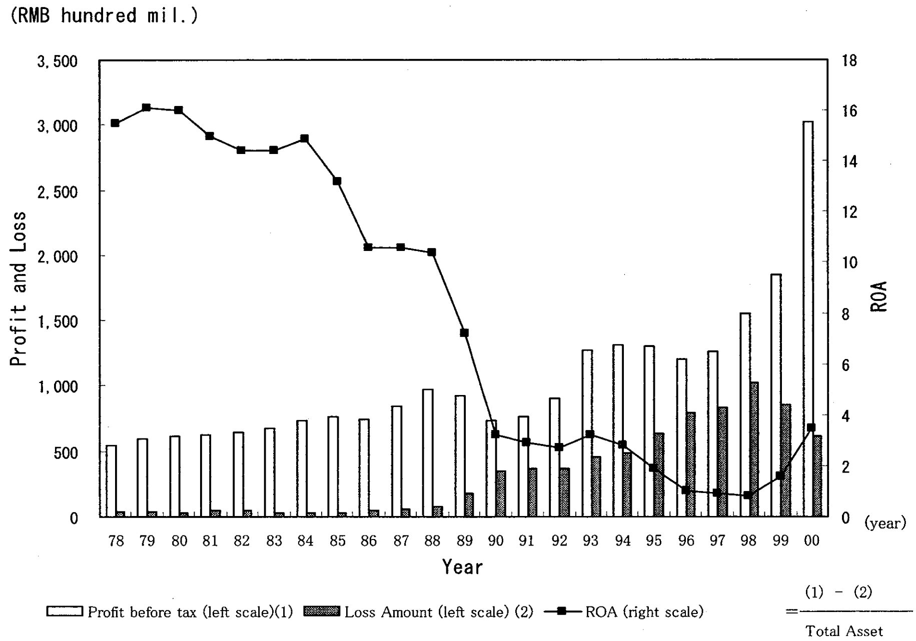
Net cost under baseline (see prior table)	30
With higher NPL[1]	44
Higher NPL plus lower recovery rate[2]	51
Memo:	
Additional cost of support for policy banks	~+5
Additional cost of lowering NPL ratio to 7.5%	~+2
Range of possible cost	30 to 58

1. NPL for SOCBs of 40 per cent and co-operatives of 66 per cent.
2. Recovery rate of 5per cent versus 15 per cent in baseline.
Source: OECD

On the macro basis, OECD estimated that the NPL clean up cost would be from 30% to 58% of GDP[10]. The next two tables show the estimates in an OECD report. They seems to be rough calculation but considering the difficulty of obtaining accurate NPL figures, a wide margin of error is unavoidable. If China continues its growth without interruption, the OECD report suggests that the grow-out strategy on the macro economy level would be quite possible. In this calculation the cost related to the existing NPLs will be born by the government, and even in the worst case scenario, the NPLs would be 58 % of the total GDP of 2000. If GDP grows 7% yearly, then GDP will be

[9] Asian Policy Forum [2002]
[10] OECD [2002] In its calculation, OECD assumes that the whole cost of NPL recovery will be covered by the government and that the SOCBs need no capital injection except the NPL cost. JS, City banks and co-operatives need additional capital injection to keep their capital ratio.

Figure 2 Profit and Loss Situation of SOE



Note: Profit before tax is the total profit of profit-making corporations and loss amount is the total loss of loss-making corporations.
Source: *China Statistical Abstract*

double in 10 years and the cost in per cent of the GDP will become half of the initial burden.

However, such a view seems to be too optimistic. Even if the grow-out strategy is possible, there are several conditions to be fulfilled. One necessary condition for such a grow-out strategy to work is that the system which accumulated the NPLs will no longer be the same. To prevent NPLs increasing further, SOEs, the major borrowers of SOCBs, must improve their profitability.

Although there are many cases of reported improvements in the profitability of SOEs, further efforts have to be made. The next chart shows that the profits of SOEs in total are increasing after '98.

In the past, the so-called "soft budgeting" and "policy loans" have caused many problems.[11] As mentioned earlier, China established three policy banks and separated the functions of commercial banks and policy banks. SOCBs have been ordered to decrease NPLs and their branches have been ordered by their head quarters to reduce NPLs and at the same time to make profits. In spite of such positive developments, SOEs seem still to be over-capacity, over-employed and financially not independent from SOCBs. OECD reports pointed out the continued lending to loss-making SOEs which

[11] Wei[1999] 187p-189p

suggests that considerations beyond strict commercial criteria still play a role in a significant amount of lending[12].

(b) Strengthening corporate governance of banks

In order to improve such a situation, it is essential to strengthen the corporate governance structure of the Chinese banks, especially SOCBs. Mr. Liu of Bank of China mentioned, in the same ADBI meeting, the necessity to strengthen the corporate governance of the SOCBs.[13] In order to achieve this he stressed the importance of SOCBs recapitalizing through equity and bond issuance in the capital market. Corporate governance will be strengthened once banks are subjected to market discipline and investor scrutiny. At the same time accounting systems and disclosure of financial conditions should be strengthened.

CCB was reported to be planning to list their shares in China, Hong Kong and New York in three to five years[14]. Other two SOCBs, BOC and ICBC are said to have intentions to list their stocks domestically and overseas. Such listing will contribute to strengthening corporate governance and these efforts should be promoted further.

(c) Liberalization of interest rates

In China the renminbi interest rates on deposits and loans have been regulated and banks have not been free to fix interest rates at all. In the inter-bank money market and inter-bank bond market China started liberalization in 1996[15]. In January 1996 China launched a nationwide unified inter-bank call market and liberalized China inter-bank offered rate (CHIBOR) in June of the same year. In June 1997 the inter-bank bond market (repo market) started. A market-based auction method also began to be used in October 1999 for all government bonds issued by the Ministry of Finance. Government bond yields in the secondary market have been liberalized.

Liberalization of interest rates both for deposits and loans is a necessary step towards an efficient financial market. Interest rate liberalization enables the financial system to allocate the financial resources to areas where true and productive investment opportunities exist. China abolished policy lending of commercial banks. However, the alternative system does not seem to work efficiently, and without the liberalization of interest rates it would be very difficult for the financial system to function as and effective intermediary.

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[12] OECD [2002] 459p
[13] Liu [2002]
[14] Nikkei Financial Newspaper Nov. 14, 2002
[15] Wei [2001]

There have been good reasons for China to keep interest rate regulation in the past. Song named several reasons why China cannot liberalize interest rate regulations[16]. They are fragmented market structures, the large number of non-performing loans held by state banks, the risks to the domestic banking sector from greater competition, the need to meet macroeconomic policy goals and an inadequate financial infrastructure.

Wei, in his comprehensive analysis of China's banking system in 1999, also analyzed the problems of regulated interest rate structures and proposed possible ways to liberalize interest rates[17]. According to his and the World Bank study, there are five conditions for interest rate liberalization.[18]

Savings must be interest rate elastic. Investments must be interest rate elastic. Banks must be financially sound and solvent. The central bank must be able to conduct monetary control by relying on market-based monetary instruments. And there must be a high standard of prudent bank supervision.

Are these five conditions fulfilled in China? Wei found that the first condition is met. Household savings and interest rates are correlated in China. The second condition has not been fulfilled, because the SOEs tend not to manage their investment based on interest rate levels. The situation is not so different even today. The verdict on the third condition, of sound banks, is self-evident. The banks still hold large NPLs even today. The fourth condition is now being fulfilled because the central bank has changed its policy instruments to indirect control from direct control. PBOC has changed their monetary policy to indirect control. The fifth condition of prudent bank supervision has been improved and will be improved further. Most of Wei's results seem to be applicable in China today, and its interest rate liberalization process should be promoted very carefully.

China started to liberalize interest rates very recently. In 1999 the PBOC issued its policy to liberalize interests in China and defined the priorities . According to this schedule, the RMB interest rates will be liberalized within three years. Foreign currency deposits and loan rates will be liberalized. Then the RMB interest rates will start to be liberalized in rural areas and later it will move to urban areas. Liberalization will start with deposits, then later move on to loans[19]. In this manner the PBOC started its careful and gradual move to liberalize interest rates.

Wei discussed the sequence problem of interest rate liberalization. Which should be

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16 Song [2001]
17 Wei [1999]
18 Wei [1999] p. 161.
19 PBOC is experimenting interest rate liberalization in nine counties in four provinces. Rural credit co-operatives in the region can float their savings rates by up to 30 per cent and lending rates can also be floated to a maximum of 70 per cent, based on the credibility of borrowers and negotiation.

the first, deposit or loan? Wei, in his analysis, proposed to liberalize deposits first and then to liberalize loans. The first reason was that he thought that the deposit rate would decrease because Chinese real interest rates are very high and interest rates would fall once deposit interest rates were liberalized. The second reason was that the SOEs will be put in a more difficult position because of higher loan rates.

Most of the market participants and authorities think on the contrary, that liberalizing deposit rates will lead to higher deposit rates and will hurt the profitability of banks. Therefore, the PBOC should start to liberalize interest rates on loans first.

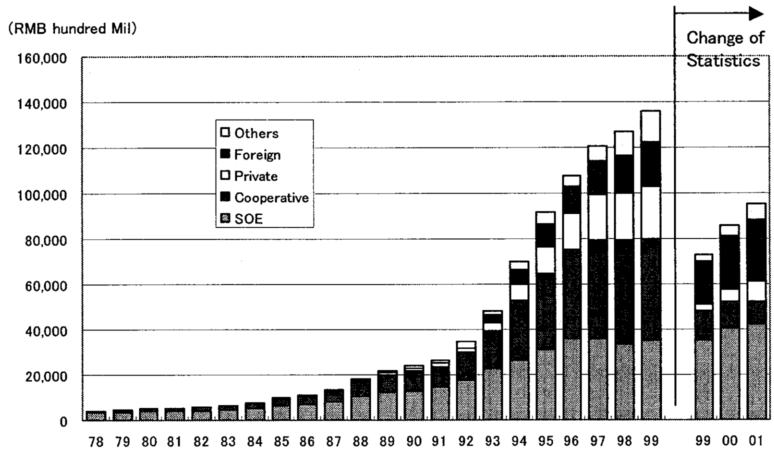
This sequence, to liberalize loan rates first, is the right choice, contrary to Wei's opinion. When banks apply flexible interest rates, they will be ready to provide the SMEs with funds. SOEs will be forced to manage more efficiently in order to get better interest rates. Banks would conduct more thorough analysis of financial conditions of clients and they will further refine their internal credit rating system. Such a move will improve the NPL problem and in turn the financial position of banks. Later on deposit rates will be liberalized and the whole financial system will function to reflect true supply and demand.

(d) Fund flow to SMEs

A very important mission of China's financial system in coming years will be to supply funds to the SMEs and to establish a level playing field for the SMEs and SOEs. SMEs are the driving force of the economy. But they are put in a disadvantageous position in fund raising in comparison with large SOEs, although SMEs are expected to make full use of China's comparative advantage in labor-intensive industries and to lead China's growth in coming years. The share of SOEs in industrial output of China has been decreasing constantly and their share in urban employment and in total investment have been declining (Fig. 3). The share of SOEs was close to 80 per cent of the total industrial production in the early 80s and 28.2 per cent in 1999. On the other hand, the share of collective firms, self-employed and others including private firms increased dramatically.[20]

[20] Wang [2002] p. 30.

Figure 3 Industrial Production and Share of Different Coporation Types



Note: After 2000, the statistics changed to covers SOE and non-state enterprises whose sales are over RMB 5 million

Source: *China Statistical Yearbook*

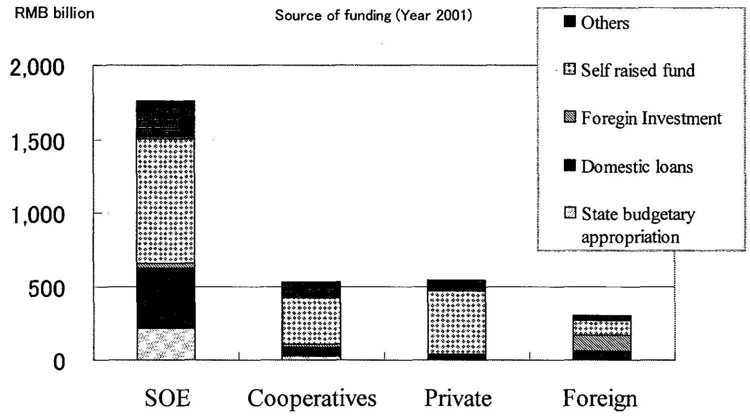
In spite of this increasing role of SMEs, an extensive survey conducted by International Finance Corporation in 1999 found that private enterprises relied almost exclusively on their own funds for their growth[21]. Nearly 80 per cent of the firms surveyed cited lack of access to finance as a serious constraint. At the end of 1998 bank loans and lending by other institutions to the private sector together constituted only one percent of the total lending. The equity market has also played a limited role for private enterprises because China's equity market has served primarily to finance SOEs. The major source of financing for private corporations is self-raised funds. They also rely more on informal markets, which offer quick and flexible financing, than on formal bank lending, although interest rates charged in the informal market are higher than those in the formal market.

The figure 4 shows that the cooperatives and private enterprises, which consist mainly of SMEs, are relying less on loans.[22]

[21] IFC[2000] p. 45.

[22] In the figure 4, loans include not only bank loans, but loans from non-bank financial institutions, and central and local government. Self-raised funds refer to funds received by construction enterprises from their higher responsible authorities, local governments, or raised by enterprises or institutions themselves. Self-raised funds are different from internal financing of depreciation plus earnings in the western meaning. Self-raised funds, therefore, are different from internal financing of depreciation plus earnings in the western meaning. They may include supporting by regional and other governments. Therefore, it would not be appropriate to understand SOEs' conditions only by this graph and their true situations are opaque.

Figure 4 Source of Funding (Year 2001)



Source; *China Statistical Yearbook*

The liberalization of interest rates will enable banks to provide funds at realistic rates, which may be higher than bank lending rates now. But small profitable corporations can borrow and invest such funds in a more meaningful way than SOEs.

In order to make more funds available to SMEs, SOCBs should develop skills to evaluate their clients properly, not only the financial conditions of corporations but also their technology and management skills. SMEs have difficulty in providing collaterals or third-party guarantees. Many cities established credit guarantee agencies and such efforts will improve SMEs' access to bank lending.

In order to make China's economy competitive enough for the WTO opening, improving the access of SMEs to more flexible bank lending is very important.

(e) The role of foreign banks

In the development process of China's financial system, foreign banks will play important roles and their activity should not be curbed or disturbed as far as possible. Very recently some Chinese banks have accepted foreign bank participation. Such participation will benefit China's financial system, because foreign banks will bring in new technology and services to the Chinese market. (Table 6)

Foreign institutions' participation may also contribute to improving corporate governance in China. When foreign institutions participate in Chinese institutions, they will affect their way of thinking, of management and reporting to shareholders.

Very recently China imposed a limit on the inter-bank borrowing by banks. This restriction allows foreign banks to fund inter-bank money only up to 40 per cent of their renminbi debt. This narrows the activity of foreign banks in the country and will protect

Table 6 Foreign Banks Participation

Chinese banks	Total Asset (2001, RMB billion)	Foreign banks	Share of foreign banks in capital
Shanhai Bank	n.a.	HSBC	8%
Xian City Commercial Bank	n.a.	Scotia Bank (Canada)	2%
Shenzen Development Bank	67.23	New Bridge Capital (US)	15%
Pudong Development Bank	130.7	Citibank	10%
China Minsheng Bank	68.6	Hang Seng Bank	Under negotiation

Source: *Almanac of China's Finance and Banking*

the banking industry from competition. However, it is not the right step forward. It would be more productive for China to develop the money market within the country and to let foreign banks lend money to companies who need such funding for new investments. It would make the Chinese industry more competitive. Therefore such restrictions should be removed as soon as circumstance allows.

3. Possible Risks caused by WTO entry

In a more liberalized environment after WTO entry, China's financial system may face new risks. One risk is that NPLs will continue to grow and China's fiscal burden will increase. The second risk is that stiff competition will hurt banks and systemic risk will occur. The third risk is that a crisis could occur caused by the liberalization of the capital accounts, coupled with a weak banking system. China is already preparing to face these risks in the future. These efforts should be strengthened with special attention.

(1) NPLs and fiscal burden

NPL solution is the first necessity before China fully opens its financial markets to foreign institutions. Without solving this problem Chinese banks will not be in a position to compete with foreign banks. As the OECD estimates indicate, the Chinese government must inject additional money into the banking system although this would add to government debt. So long as China's economic growth continues at such a high rate as 7 or 8% in coming years, this problem of fiscal burden could be under control.

However, the experience of other countries show that even a high growth economy faces difficult times and such economy falls into recession sometimes.

Concern over the growing debt of the Chinese government is already very often reported in newspapers[23]. If NPLs accumulate and the government should inject further money into the system, some are afraid that this would lead to a financial crisis. Under the current circumstances where China regulates its capital account strictly and gives implicit deposit guarantee, a financial crisis would not occur easily. However, such accumulation of government debt would crowd out private investment in the country and would hinder future growth. In order to avoid such risks, it is important to cut the vicious circle of NPL accumulation, as we have already discussed in this paper.

(2) Stiff competition and systemic risk

The second risk, that stiff competition may lead to a systemic risk, can be avoided by establishing an efficient and sound financial system. For this purpose bank regulation and supervision should be more transparent. In this context there are several reports that China is considering creating a new bank supervisory body which would take over the banking regulatory role of the PBOC. Under the current system where the PBOC has two functions, to set monetary policy and at the same time to be a banking regulator, the PBOC's decision could be biased to protect the SOCBs. If a new separate body was established it might concentrate more on supervising banks and the PBOC would concentrate on the macro-economic policy.

In order to avoid a systemic risk it is important to gain the confidence of domestic and international investors. As discussed in the earlier section, strengthening corporate governance and improving disclosure are the necessary steps. Banks should disclose their true conditions, so that the additional money can be effectively invested.

Interest rate liberalization should be promoted in measured steps, in order to avoid a systemic risk. At the same time, steps taken should be timely and not delayed. Too early a liberalization contains risks, especially when bank supervisory functions are not ready in the system. However, there is also a danger that liberalization comes too late and too many regulations remain in the system.

The Japanese mistakes are good examples of such failures. After the war, Japan opened up its market gradually and at the same time liberalized its markets one by one. Interest liberalization was completed in 1993. However, Japan had kept other regulations too long and protected Japanese banks from real market competition. The failure was mainly from the latter half of 1980s and into the 1990s. I would like to name

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[23] *WSJ;* "China's growing debts stirs debate, fuels fears", January 20, 2003

four major mistakes. The first one was that the Ministry of Finance kept the implicit and full guarantee of deposits to all banks and maintained the myth of "no bank failure". This made depositors and market participants indifferent to the risks associated with banks and caused moral hazard throughout the economy. The second mistake was that the Ministry of Finance maintained the separation of banks and security companies and also kept the separation among bank institutions too rigid and too long. There were many vested interests in the financial markets in Japan. And prohibiting banks from joining the securities business, the separation of banks like city banks, long-term credit banks and trust banks existed too long, although such separation became obsolete in the changing technological environment. These restrictions discouraged banks from developing their financial skills. The third mistake was that the Ministry of Finance kept controlling every detail of product development in financial markets and caused delay in the technical development of market participants. The Ministry of Finance was also slow to reform the tax system which hindered the creation of new financial products. And the fourth mistake was that the banks themselves were too slow to adopt better risk management system.

With the practically unlimited deposit guarantee, slow technical progress and poor risk management system, banks simply expanded the volume of loan portfolio till the beginning the 1990s, especially in risky real estate lending, which turned out to be NPLs during that decade. Japan should have liberalized the financial markets in the 80s more than they did and should have let banks control their risks by themselves independently and let them compete in a true sense.

China should achieve financial reforms like interest rate liberalization and start stiff competition with foreign banks in much shorter time than Japan did. Enough care should be paid in this process: but at the same time, they should not wait too long to deregulate the industry. The existence of many regulations may cause banks to avoid competition without good economic reasons as in the case of Japan.

(3) Capital account liberalization and a weak financial system

WTO entry also affects China's foreign exchange policy. WTO entry doesn't mean change in its foreign exchange rate policy directly. However entry will make it more difficult for China to maintain its fixed exchange rate peg to the US dollar. There are two reasons.

The first is that an open market economy needs the flexibility to adjust exchange rates. Entry to the WTO means that China will liberalize its trade and when an imbalance occurs in trade, then the exchange rate becomes one of the important instruments to adjust such an imbalance. China cannot always rely only on fiscal expenditure or monetary policy to do this and will need exchange rate flexibility.

The second reason is that opening the capital market will be inevitable when the Chinese economy becomes more open to the world. China currently controls the capital accounts fully, and is unlikely to ease such a control in the short run, in order to avoid any abrupt movement of capital across the border. It will be more difficult, however, to control the movement of capital in the future because investors and corporations who invest in China will request more freedom to move capital across borders. Even Chinese corporations will start to invest abroad, when they get competitive internationally, as Haier does[24]. Dynamic movement of capital is essential for industrial economies and to try to curb it will be very counterproductive.

For these reasons, China will have to loosen capital account control gradually and if China tries to keep the rigid fixed rate peg to the US dollar, it may face a very large and abrupt adjustment process. The Asian financial crisis showed how severely such adjustment can hurt the countries concerned. The fixed rate peg may cause an imbalance in the balance of payments. Although China has large foreign exchange reserves at the moment, the situation could change rather quickly.

In order to avoid such an abrupt currency risk, China should move to a more flexible exchange rate system. At the same time, banks should develop their internal risk control system as part of strengthening the financial system. One way to move to a more flexible exchange rate system would be to adopt a currency basket system.[25] Improving financial cooperation with other Asian countries would also be important.

4. Conclusions

China is facing enormous challenges to reform its economy within a limited timeframe. Necessary reforms are many-sided and need extreme care, but at the same time, they require speed. It is a tremendous challenge. Long Yongtu wrote in his book that tougher and more significant part of the WTO negotiation was consensus-building among the Chinese and it turned out to be an unprecedented, massive education process for them regarding globalization and the restructuring of the economy[26].

As Yongtu wrote, the WTO entry is a process accompanied by tremendous degree of changes, especially in the way people think. And in this process, pains may somehow be

[24] Recently it was reported that China started a trial to ease the restriction on foreign investment by Chinese companies. See *South China Morning Post,* Jan. 20, 2003 and *WSJ,* Jan. 20, 2003
[25] Mori, Kinukawa, Nukaya and Hashimoto [2002]
[26] Yongtu [2002]

controllable but they are inevitable.

Mr. Keating, the former prime minister of Australia, referred in his speech in Beijing last year to financial reform in China[27]. He recognized the problems of China's financial system, but at the same time he mentioned that the Chinese leaders and the central regulatory organizations like the PBOC and the CSRC understand these problems fully. And he was optimistic about China's reforms believing that China will be the engine of growth for its neighbors. Many people would agree with him on this point.

China's WTO entry is offering the best opportunity to accomplish this difficult job.

[27] Keating [2002]

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Annex China's commitments to financial industry reform in the banking sector:

Geographic coverage

Banking and other financial services

Foreign currency business	no geographic restrictions since accession	
Local currency business	geographic restrictions will be phased out as follows	
	Upon accession	Shanghai, Shenzhen, Tianjin and Dalian
	within one year after accession	Guangzhou, Zhuhai, Qingdao, Nangjing and Wuhan
	within two years after accession	Jinan, Fuzhou, Chengdu and Chongqing
	within three years after accession,	Kunming, Beijing and Xiamen
	within four years after accession,	Shantou, Ningbo, Shenyang and Xian
	Within five years after accession	all geographic restrictions will be removed

Clients

For foreign currency business	upon accession	foreign financial institutions were permitted to provide services in China without restriction
For local currency business	within two years after accession	foreign financial institutions will be permitted to provide services to Chinese enterprises
	within five years after accession	Foreign financial institutions will be permitted to provide services to Chinese individuals. Foreign financial institutions licensed for local currency business in one region of China may service clients in any other region that has been opened for such business.

Licensing

-Foreign financial institutions with total assets of more than US$10 billion (at the end of the year prior to filing the application) are eligible to establish a subsidiary of a foreign bank or a foreign financial company in China. Such institutions are also eligible to establish a Chinese-foreign joint venture bank or finance company. Foreign financial institutions with total assets of more than US$20 billion (at the end of the year prior to filing the application) are eligible to establish a branch of a foreign bank in China.
-Qualifications for foreign financial institutions to engage in local currency business are as follows: three years business operation in China and a record of positive profits for two consecutive years prior to the application.

Auto financing

-Foreign non-bank financial institutions were permitted to provide auto financing upon accession.

(Source: OECD)