From Beijing Consensus to Washington Consensus (II)

China's Financial Sector under the WTO Regime: A Preliminary Assessment

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With China's entry into WTO in 2001, the debate on the potential losses and gains has really picked up. Given the diverse perspectives, there is no consensus on the potential gains and losses due to the WTO accession. In my opinion, China could substantially gain in some sectors of economy, particularly garments and automobiles industry, while in other sectors of the economy, the country could be a net loser. The financial sector of China, consisting of banking, insurance and securities markets is one of the sectors where the potential losses outweigh potential gains.

Historically, the financial system of China was structured to serve the needs of the planned economy. Even when liberalization program was initiated in 1978, China took special measures to protect this sector. As a result, there has been very limited liberalization (both domestic and international) since 1978. The Chinese authorities put severe restrictions on the entry and operations of both domestic and foreign banks and financial institutions. Thus, it would not be wrong to say that China has always treated the financial sector as a special industry and therefore accorded special protection. The ideology was in direct contrast with the neoliberal agenda which does not distinguish between financial sector and other sectors of the economy.

Given the fact that China has already announced a rapid financial sector liberalization program to facilitate its entry into the WTO, the authorities would find it difficult to accord special protection to the financial sector. Market access and national treatment are integral part of the WTO accord. There are two components of WTO which would pave the way for financial sector liberalization in China. The first one is the General Agreement on Trade in Services (GATS) and other is Financial Services Agreement (FSA). More than 100 countries have already signed the FSA. The spectrum of FSA is so broad that it almost covers 95 per cent of global banking, securities and insurance markets.

Let me elaborate on the implications of China's accession to the WTO on its financial sector.

Banking Sector: China's financial system, like that of Japan, India and Germany, is essentially a bank-based system. The public sector banks in China have played a central role in mobilizing savings from public and making it available to state-owned enterprises (SOEs) and others. Although in recent years, the Chinese authorities have granted operational autonomy to the banks, but bulk of China's banking system is still owned by the government. Table 1 gives the list of China's top 10 banks. The top four state-owned banks account for nearly 80 per cent of total assets. The rest of the assets are owned by development and commercial banks.

Table 1: Top 10 Banks of China (2002)

Ranking	Bank	Assets (US$m)
1	Industrial and Commercial Bank of China	524235
2	Bank of China	406150
3	Agricultural Bank of China	305431
4	China Construction Bank	334061
5	Bank of Communications	80836
6	CITIC Industrial Bank	36258
7	China Merchants Bank	32176
8	China Everbright Bank	32066
9	Guangdong Development Bank	23101
10	Shanghai Pudong Development Bank	21013

Source: *The Banker*, October 2002.

Till now, the operations of foreign banks have been very limited with severe geographical and business restrictions placed on them. Foreign banks in China were confined to foreign currency business, that too with foreign corporations. It was only in 1996 that foreign banks were allowed in Shanghai to accept local currency deposits from foreign-funded enterprises and extend local currency loans to them. In 2001, 65 foreign banks with only 180 branches were operational in China. The domestic currency assets of foreign banks were only 47.8 billion yuan in 2001.

Table 2 highlights the major concessions granted by China to foreign banks under the WTO deal. Foreign banks have been allowed to conduct all types of foreign exchange transactions with foreign clients immediately upon accession to the WTO while geographical restrictions for local currency business will be phased out in the next five years. As a result, there would be no geographical and client restrictions on foreign banks to operate in China by the year 2006. This would serve as a major boost to the foreign banks as they have been waiting to capture the banking markets of China, which have almost a trillion dollars in personal savings.

The wider implications of such a rapid liberalization of banking sector could be discerned in the near future. But a cursory assessment points towards several disturbing trends. Firstly, foreign banks would have access to domestic market in a very short span of time. In particular, foreign banks would capture markets in those regions (e.g., coastal regions and cities) where bulk of banking business is concentrated. Given the fact that foreign banks have considerable international exposure and can launch new products (e.g., ATMs,

Table 2: Timetable of China's Banking Sector Liberalization under the WTO

	2002	2003	2004	2005	2006
Enterprises Banking	Local currency business with foreign enterprises in 4 cities: Shanghai, Shenzhen, Tianjin, Dalian Foreign currency business with foreign & Chinese enterprises (without geographic restrictions)	Four additional cities: Chengdu, Qingdao, Nanjing, Wuhan	Local currency business with foreign & Chinese enterprises Four additional cities: Fuzhou, Chengdu, Jinan, Chongqing	Four additional cities: Zhuhai, Beijing, Xiamen, Kunming	Four additional cities: Ningbo, Shenyang, Shantou, Xian
Retail Banking	Foreign currency business with Chinese clients (license is required)				
Investment Banking	Establish securities operation as a joint venture with a minority (up to or equal to 33.33%) equity share for foreign investors to underwrite A & B shares		Increase to 49% equity share		
Asset Management	Manage assets through a joint venture with foreign minority equity share (up to or equal to 33.33%)		Increase to 49% equity share		
Auto Finance	Auto financing without any market access or national treatment limitations				

credit cards, etc) and provide better services, they are in a better position to capture China's banking businesses. Foreign banks would also dominate the highly lucrative trade-related businesses.

Secondly, the opening up of the banking sector would pose no immediate threat to the big four state-owned banks because they have vast branch networks in both urban and rural areas. But the worst sufferers of opening up would be small- and medium-sized commercial banks in China. These banks provide credit to small- and medium-sized companies in China who are the engines of economic growth in China. Therefore, it seems likely that less credit would be available to small- and medium-sized companies in future which, in turn, would have negative repercussions on the economic growth.

Thirdly, China is likely to witness the emergence of a new banking system, popularly known as class banking. Till now, Chinese state-owned banks have been geared towards providing banking services to the people in both rural and urban areas. But the Chinese business elites and neo-riche remain unhappy with poor quality of service rendered by domestic banks coupled with the fact that they do not maintain secrecy norms about their clientele. By allowing foreign banks to offer banking services to Chinese citizens, elites and neo-riche are likely to move their savings from state-owned banks to foreign banks that can offer efficient services, and new products (e.g., credit card, debit card, ATMs). It has been estimated that about 10-15 per cent of savings in state banks would move to foreign banks. Given the fact that the survival of many SOEs depends on getting loans from the state banks, such a shift of savings could pose severe threats to the entire economy. If such a massive shift in banking occurs within a short period, the state banks won't be able to support the SOEs, and as a result many SOEs may go bankrupt. This is an issue which requires closer attention by the Chinese authorities.

Lastly, there would be massive job losses in the domestic banking industry. China is one of the countries whose banks have a very high employees/assets ratio. The entry of foreign banks is not likely to increase workforce in the banking sector given their heavy reliance on computers and IT. On the contrary, workers of domestic banks would loose jobs in the event of mergers and acquisitions being carried out by foreign banks.

There is no denying that China's domestic banks are nowadays going through a difficult period. The levels of non-performing loans (NPLs) in the Chinese banking system are very high. Although there are no correct estimates of total NPLs of the banking system, it is estimated that these are 20 per cent of total loans and approximately 25 per cent of the gross domestic product (GDP) of China. Most of these NPLs were created during the post 1978 period when the government decided not to directly subsidize the SOEs and ordered them to take loans from state banks. In recent years, the Chinese authorities have tried to deal with the growing NPLs by setting up public-funded asset management companies (AMCs) but little progress has been made by these entities. However, it is important to stress here that the NPLs of China are different from NPLs of Asian countries like Thailand and Korea. We have witnessed transfer of huge public money to the private sector in Thailand and Korea in the aftermath of financial crisis. While the problem of NPLs in China is essentially between state-owned banks and state-owned enterprises. If the Chinese authorities wish to write off the loans, that would only require a transfer in accounting books.

Securities: Given the domination of bank-based financial system, the securities market of China remained under-developed. Severe restrictions were placed on both domestic and international financial institutions to curb their activities in securities market. For instance, foreign investors were only allowed to trade in B shares, the shares of Chinese companies listed in China. While domestic investors were allowed to trade in only A shares, the share of Chinese companies listed in China. H shares are Chinese company shares listed in Hong Kong. By segregating the shares into three categories, the Chinese authorities were success-

Table 3: Timetable of China's Insurance Sector Liberalization under the WTO

	2002	2003	2004	2005	2006
Insurance	Non-life insurance - branch and joint-ventures at 51% equity share permitted Life insurance - joint-ventures at 50% equity share permitted Insurance for enterprises located abroad, property insurance, related liability insurance and credit insurance for foreign invested companies Life & non-life insurance in Shanghai & Guangzhou		Wholly-owned subsidiary permitted in 10 cities	Geographic restriction will be removed	Non-life insurance services to both foreign and Chinese clients

ful in curbing the domination of foreign financial institutions besides ensuring stability in its securities markets.

Under the WTO deal, the Chinese authorities have offered several concessions to foreign financial institutions to enter into its securities market. The foreign institutional investors have been allowed direct dealing in B shares besides 'special' membership in Chinese stock exchanges. By 2005, 33 per cent joint venture securities firms would be allowed to underwrite A, B and H shares and trade in B and H shares and bonds. Besides, upto 49 per cent joint venture fund management firms could be within three years.

In late 2002, China has allowed foreign institutional investors, brokerages, banks, insurers and pension funds to trade the yuan-denominated A share markets with the condition that they must invest the equivalent of between $50 million and $800 million in A shares, and keep their money in the country for a year.

The immediate consequence of these concessions is that foreign securities firms would increase their presence in the securities markets. Besides playing a major role in the Chinese securities market, foreign investment banks and institutions would also capture the underwriting businesses, which is going to witness a major boom in the next few years as more and more Chinese companies are going to offer initial public offerings (IPOs).

Table 4: Potential Benefits and Costs of Financial Sector Liberalization Under WTO

Potential Benefits	Potential Costs
• Increased customer choice, new financial products and services	• Loss of market share to foreign banks and financial institutions
• Greater access to foreign capital	• Reduced profitability because of worsening customer structure
• More sophisticated financial management skills because of know-how transfer by foreign banks	• Worsening quality of loan portfolio
• Access to international lending and investment practices	• Increase in non-productive investment and speculative activities
• Increased transparency	• Systemic risk in banking system
	• Speculative pressure on currency
	• Increased volatility in the financial system
	• Loss of policy autonomy to deal with volatile capital flows

Insurance: As of now, the domestic insurers enjoy 99 per cent market share in China. The opening up of insurance sector to foreign firms has remained controversial ever since China expressed its eagerness to join the WTO. Already China's insistence for granting special treatment to the US insurance giant, AIG, has run into trouble with EU, which consequently delayed its entry into the WTO.

China's domestic insurance sector is going to witness a major shake up with the WTO deal which gives several new concessions to the foreign firms, some of which are listed below:

1. Licenses will be granted on a prudential basis and without any numerical restrictions.

2. Foreign insurers can own 50 per cent of a life insurance venture and 51 per cent of a non-life insurance venture.

3. Foreign insurers can enter into health, casualty and pension insurance.

The domestic insurers would face stiff competition with the liberalization of insurance sector. The domestic insurers would be squeezed out and the real competition would be between the giant US and European insurance corporations.

Macro Financial Indicators: At the moment, the macro economic fundamentals of China are very strong. China has very comfortable foreign exchange reserves, over US$240 billions, next only to Japan. The total external liabilities of China are estimated to be around $150 billions. It is important to highlight here that the bulk of external liabilities of China (about 80-85 per cent) have long-term maturities thereby posing no immediate financial crises such as the one witnessed in South Korea. The debt service ratio (i.e. debt service as a percentage of exports) is low. In addition, China has been running trade and current account surpluses for decades. Saving rates are very high, averaging at 40 per cent in the 1990s. All these indicators show that macro economic position of China is quite resilient.

However, China's entry into WTO poses new kinds of macro economic challenges. Till now, China's currency is not fully convertible. That is one of the major factors why it escaped from East Asian financial crisis. But once its financial sector is fully opened up for speculative financial flows, it would become the battleground for global speculators and fund managers to speculate on its financial assets and currency. We have already witnessed the negative consequences of financial liberalization in East Asia and other emerging markets. The question whether China would go the East Asian way cannot be wished away.

Undeniably, one advantage with WTO is that it would also open up opportunities for the Chinese banks, insurance and securities companies to compete in international financial markets. But this is unlikely to happen for two reasons. Firstly, Chinese banks and firms do not have any experience in dealing with international financial markets and financial products like derivatives. Secondly, the real challenge for Chinese banks and insurers would be to hold their own in the domestic markets, rather than looking for opportunities in international markets.

Lastly, much of economic growth in China in the 1980s and 90s came from exports. However, this export-led growth is unlikely to be sustained in the coming decades. The bulk of economic growth would come more from domestic sources (e.g., housing, infrastructure development, etc.). But the paradox is that Chinese authorities would not be able to sustain domestic economic growth because globalized finance capital makes it difficult for countries to even pursue moderate Keynesian policies. Therefore, the opening up of the financial sector would make the task difficult for the Chinese leadership to maneuver economic policy to its advantage.

The earlier strategy of limited financial liberalization has been turned upside down by WTO dictated timetables for rapid financial liberalization. Since the Chinese authorities are determined to go ahead with financial sector liberalization program, it remains to be seen how China would adjust to one-size-fits-all strategy.

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