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The Impact of WTO Accession on China's Financial System¹

Abstract

This paper evaluates the impact of China's entry to the World Trade Organization (WTO) on its financial system. This new agreement, which opens China's market, may contribute to the country's financial development by introducing more competition and efficiency, as conventional wisdom illuminates. However, it is also possible that the fragile financial system will be exposed to much greater risk if the Chinese government can not put an end to the practice of using the banking system and the stock markets as a means of raising funds to rescue ailing state-owned enterprises.

China's big state-owned banks appear ill-prepared to meet the increased competition from foreign banks that will follow China's entry into the World Trade Organization.

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²Nicholas R. Lardy, 'China's Worsening Debt', *Financial Times*, 22 June 2001.

In the first twenty years of its reform and opening, China has transformed itself from a self-sufficient socialist autarchy to one of the top ten trading countries and the second largest foreign investment recipient in the world. It is to everyone's benefit – the world's and China's alike – for China to join the World Trade Organization (WTO). On one hand, it could embrace China, the largest non-member trading state, as part of the trade regime; on the other hand, it could provide a new momentum for China to further liberalize its economy.

Since the conclusion of the Uruguay Round of trade negotiation in 1994, the scope and depth of demands for entrants into the WTO have increased substantially. The General Agreement on Trade in Services (GATS) of the Uruguay Round and the subsequent agreements on telecommunication, information technologies, and financial services have extended negotiations for WTO membership into those areas, which have been traditionally off limits to foreign firms. In other words, the bilateral negotiations and protocol for China's accession to the WTO has demanded a much wider opening of domestic markets than the requirements for members who joined the organization during the GATT era.³

The financial sector is one of the new areas, which has been added to the negotiations for WTO accession. In the meantime, despite the astonishing performance of China's economy, generally in opening its market to the outside world, the financial sector remains largely, if not completely, insulated from the world economy. As a result, it is among the least efficient and competitive sectors in today's China. However, the financial sector has played a crucial role in underpinning China's smooth transition toward market economy. This includes mobilizing domestic savings to finance the survival of ailing state-owned enterprises (SOEs) and thereby, preventing China from heading down the tumultuous transition-path of 'shock therapy'. In this context, the financial sector can serve as a 'crucial case'⁴ from which to examine the impact of

³ For a detailed discussion of the Uruguay Round and the General Agreement on Trade in Services, see Geza Feketekey, 'Trade in Services – Bringing Services into the Multilateral Trading System,' in Jagdish Bhagwati and Mathias Hirsch (eds), *The Uruguay Round and Beyond* (The University of Michigan Press, 1998).

⁴ 'Crucial case' usually refers to the 'least likely' case to test social science theories. See Gary King, R. O. Keohane, and Sidney Verba, *Designing Social Inquiry: Scientific Inference in Qualitative Research* (Princeton University Press, 1994). Here the term is used to indicate

China's entry into the WTO. If China's financial institutions are able to harness the momentum of WTO accession to rid itself of the burden of providing endless financial support to ailing SOEs and instead, can launch a large-scale restructuring of the whole sector, they may finally be able to transform themselves into real market players and compete with both foreign and domestic private firms. A successful transformation of the financial system could not only resolve the problems of the financial sector itself, it could also increase the economy's productivity by allocating financial resources more efficiently. As such, a true change in the financial system is vital for the sustainability of China's economic growth in the coming years.

It is equally important to note, however, that this transformation will also require tremendous economic costs and political risk as sealing off the financial support for ailing SOEs means the termination of benefits to numerous state planners and workers, which is the traditional core constituency of the Communist regime. According to the latest numbers available, the Chinese government remains reluctant to take the risk, leaving financial institutions to play the critical role of helping to share the government's fiscal burden. As a result, the financial system in general, is far from ready for the competition, which will accompany WTO accession.

A brief discussion here of the history and current status of China's financial system will be followed by an analysis of the potential benefits and possible challenges of WTO accession to its financial system. The conclusion, based on this analysis, is that if the Chinese government does not cease in utilizing the financial system as a vehicle for raising funds to shore up unprofitable SOEs, the financial sector will be the weakest link in the up-coming competition created by China's accession to the WTO.

A Brief History and the Current Situation of China's Financial System

The financial system is one of the sectors, which has experienced the slowest progress in China's transition toward market economy. Although China embarked on its reform and opening policy in 1979, the traditional socialist monobank system was left untouched until 1984. At that time, the People's Bank of China (PBOC) transferred its commercial banking functions to four

the least likely successful case in the competition following China's WTO accession.

newly established specialized banks and assumed the role of China's central bank. A two-tier banking system was subsequently established to serve as the main body of a quasi-monobank system in which the central bank still tightly controlled credit allocation made by the four specialized banks through a credit plan. The credit plan was formulated annually through repeated negotiations between various ministries, as well as, different levels of government. A sub-lending scheme was also set up between the central bank and the four specialized banks to facilitate implementation of the credit plan through redistribution of funds between banks and regions. In spite of crises, which occurred in twelve or more industrial and regional banks, as well as in numerous non-banking financial institutions (NBFIs) since the late 1980s, the four specialized banks still dominated China's financial landscape by controlling more than 70% of total domestic savings by the end of 1999.⁵

Over the years, the quasi-monobank system has successfully mobilized China's rapidly growing domestic savings to finance SOEs' investment. Through the so-called 'loan for grant' (*bo gai dai*) policy, the government's budgetary burden of financing SOEs' investments was gradually taken over by the banking system.⁶ Although this practice allowed the loss-making SOEs to remain in business, it accumulated an enormous number of non-performing loans within the banking system. Additionally, the sub-lending scheme in the quasi-

⁵ The four specialized banks are also called the four biggest state-owned banks, especially after the 1993 financial reforms when these four banks were made to gradually transfer their policy lending to three newly established policy banks, which are regulated by Commercial Banking Law. The policy banks are the Industrial and Commercial Bank of China, the Agricultural Bank of China, the Construction Bank of China, and the Bank of China.

⁶ From 1983, state banks were shouldered with the responsibility of providing all the working capital needed by the state units. Additionally, they were also obliged gradually to take over the financing for fixed asset investments. In 1980, 44.5 percent of Chinese SOE fixed asset investment was financed by state budgetary appropriation and 19 percent was financed by bank loans. By 1994, only 2.9 percent of the investment was financed by the state budget while 46.5 percent was financed by bank loans. See Jiwei Lo, Meizheng Xu, and Ping Xie, *Zhongguo guoyou zhuenye yinhang shangyehua gaige* [Commercialization reforms of China's state-owned specialized banks], Beijing: Zhongguo jinrong chubanshe, 1998, p. 32.

monobank system suffered from serious moral hazard problems⁷ when the sub-lending facility provided incentives for local bank branches to maximize their lending and then expected the central bank to issue currency to finance any shortage. This resulted in cyclical inflation during the 1980s and into the early 1990s.⁸ The situation prompted the Chinese central policymakers to launch a series of reforms in late 1993 to re-construct the system. This is the point at which China's financial development entered the second stage.

Since late 1993, the quasi-monobank system has been gradually transformed into a quasi-market system through the following measures: First of all, the credit plan and sub-lending scheme between the central bank and the four specialized banks were abolished. The central bank must now control the banks' credit allocation through market instruments, such as current interest-rates and future open market operations. Secondly, three policy banks were established in 1995 to take over the policy lending, which was formerly assigned to the four specialized banks through the credit plan.⁹ Thirdly, the PBOC and the four specialized banks were reorganized to reduce local government intervention on the one hand, and on the other hand, to enhance the authority's of the Beijing headquarters over regional branches. And finally, the passage of legislation, such as the Central Bank Law, Commercial Bank Law, Company Law, Insurance Law and Securities Law, in the National People's Congress during this period has provided a legal and regulatory framework for the operation of the financial system.

Although such reform measures made significant progress in strengthening the capacity of the central financial authorities' to control over inflation and to reduce local government intervention in the banking system, the Chinese financial system as whole was still strapped by its role in raising funds for ailing state-owned enterprises. The consequence of this is that neither the

⁷ For definition of moral hazard, see Frederic S. Mishkin, *The Economics of Money, Banking, and Financial Markets*, 5th edition, New York: Addison-Wesley, Inc., 1997, pp. 36-37.

⁸ There were four cycles of inflation and recession in the period between 1978 and 1993. For a detailed discussion of the politics and economics of China's cyclical inflation during that time, see Yasheng Huang, *Inflation and Investment Controls in China*, New York: Cambridge University Press, 1996.

⁹ The three policy banks are the State Development Bank of China, the Agricultural Development Bank of China and the Import-Export Bank of China.

regulatory authorities nor the financial institutions are well prepared for the market opening following China's entry to the WTO.

Regulatory Authorities

On paper, the new Central Bank Law of 1995 recast the PBOC as an apolitical central bank equipped with market instruments with which to conduct monetary policy. In reality, China's monetary policy is made in the Central Financial Work Committee (CFWC) of the Chinese Communist Party. The PBOC is little more than an administrative organ for carrying out policies made by the CFWC. The CFWC, composed of 15 members from important Party and government planning agencies, determines bank interest rates, the appointment of high-ranking bank managers, as well as how much credit the banks have to extend for the salaries of workers laid off by SOEs. The CFWC also determines how much money the PBOC has to print to pay for government's expenditures, such as state grain procurement and the coupon interests of state policy banks. The emasculated PBOC is not only unable to control the timetable of financial liberalization, it is also toothless and poorly informed in supervising the increasingly complicated financial system. To make matters worse, the presence of the CFWC will continue to politicize the country's overall financial reform agenda, as well as the behavioural pattern of its financial institutions as the CFWC still relies on the party cells installed in each unit of the financial system to deliver its order. It is clear that the PBOC is still far from ready for the job of central banking in a globalized financial system.

The Securities Law of 1999 stipulates that the Chinese Securities Regulatory Committee (CSRC) is the regulatory authority of China's securities markets. However, the State Council Securities Policy Committee (SCSPC) is the arena in which the annual number of listings and volume of issues is determined. It is well known that the SCSPC determines the number of listings in an old-fashion, planned economy manner. The process is highly politicized. Over the years, the quotas of listings were distributed down through the administrative hierarchy as a favor from the government to assist loss-making SOEs. In many cases, the opportunity for an initial public offering (IPO) was given to the worst SOEs, which were the ones most desperately in need of funds to pay workers' salaries. This type of political logic, which was behind IPOs has

compromised the CSRC's determinants in improving the transparency of China's securities markets.

Banking System

Thanks to the positive savings rates since 1979, the financial deepening, measured by the ratio of domestic savings to gross domestic production (GDP) in China was very impressive.¹⁰ The four biggest state-owned banks, the only financial intermediaries allowed to run a nationwide network of branches, dominated the market by holding approximately seventy percent of total savings. The newly established regional and industrial banks accounted for an additional ten percent of the market. The balance was shared between other non-state financial intermediaries, which generally existed in the form of non-banking financial institutions (NBFIs).

Constrained by the credit plan, the four biggest state banks have long been troubled by mounting bad loans, low profits, and minimal capital adequacy. Regardless of their dominant status in China's financial market, it is no secret that the four state banks are technically insolvent. The financial reforms introduced since 1993 have partially addressed these problems, but there is still no sign of improvement in the big fours' balance sheets. The most recent investigation found that even in the Bank of China, the best of the four, non-performing loans accounted for 39% of the bank's loan portfolio.¹¹ At the same time, the fiscal health of the other banks and NBFIs, is also deteriorating. The newly established commercial banks, with local governments and SOEs as their major clients, also suffered non-performing loan problems and declining profitability. The condition of NBFIs, as a result of the central government's efforts in recent years to clean-up these sectors, is even worse. The rate of return for financial intermediaries as a whole is surely negative as it is hard to imagine how they will be able to compete once the domestic market really opens up to foreign banks.

¹⁰ From 1979 to 1997, while nominal GDP grew ten times, bank deposits increased 20 times, so that the bank deposits to GDP ratio rose from 0.33 in 1979 to about 1 in 1997.

¹¹ See Nicholas R. Lardy, 'China's Worsening Debts', *Financial Times*, 22 June 2001.

Financial Markets

Like most developing countries, China has a very low degree of securitization. The two stock exchanges, the Shanghai and Shenzhen Stock Exchanges, were established in 1990 and 1991, respectively. Two types of shares are traded in the markets: A shares are exclusively for Chinese nationals, and B shares, until early this year, were limited to foreign investors. By the end of 1999, there were 1029 companies listed in the two markets; 921 in A shares and 108 in B shares, with a market capitalization of 2.65 trillion Yuan.¹² The size of the bond market is much less significant because the majority of government bonds are held by individuals, not institutions and secondly, the coupon rates for non-government bonds are set very low. The markets are very thin with poor liquidity.

As mentioned previously, the quotas for stock and debt listings are formulated by the state planning agencies and distributed down through the government's hierarchy in the same manner as a planned economy. Moreover, in order to ensure state control, less than 33 % of listed companies' shares are traded in the markets. The majority of shares are held by the government in the form of controlling shares of legal persons. As such, regardless of the rapid development of the stock markets, the SOEs managers are still being held accountable by their Party bosses, rather than the shareholders.

The unfavorable position of the shareholders is not improved by the structure of the stock markets, which is dominated by numerous small investors (The latest number shows there were 60 million individual accounts in China).¹³ Several so-called 'fund managers' play the role of price manipulator, or *zhuangjia*, by using rumors to misguide small investors. Given the fact that most companies are listed exactly *because of* their deteriorating financial situation, the financial authorities are reluctant to take seriously the task of improving market transparency. In the meantime, the markets are suffering from a terrible shortage of legal and accounting professionals. The stock markets are still based more on speculation rather than on investment.

¹² *Almanac of China's Finance and Banking*, 2000, p. 412.

¹³ See 'In China, Stock Scams Burn Small Investors', *Washington Post*, 3 September 2001.

Foreign Participation

To date, foreign participation in China's financial markets is generally restricted to hard currency operations. This is precisely why entry into the WTO is seen as such a significant event in China's financial development.

At the end of 1999, there were 247 representative offices and 156 foreign bank branches in China.¹⁴ Their operations were limited to wholesale banking and a number of foreign exchange transactions for joint ventures in approximately 20 coastal cities, with the majority being concentrated in Beijing, Shanghai, and Guangzhou. Since 1997, nine foreign banks have been allowed to conduct limited *renminbi* business in Shanghai. Nonetheless, the stringent operating requirements reduced these banks' competitiveness vis-à-vis local banks.

Foreign securities firms may establish representative offices in China, but not local branches or subsidiaries. Their operations are limited to B shares transactions and, subject to government approval, to underwriting. Additionally, all their transactions must be conducted through local brokers. So far, there are an estimated 30 foreign securities firms operating in China.

Still underdeveloped, China's insurance market has long been a darling for world insurance players. There were six fully licensed insurance companies and sixty unlicensed insurance companies running representative offices in China. Although the licensed companies were allowed to sell policies to individuals in selected cities, they were prohibited from investing in China's financial markets. At the end of 1999, foreign insurance companies together controlled less than one percent of the market and none of them were making money.¹⁵

The market share in local currency loans by foreign banks, as of the end of March 2000, was about two percent; in foreign currency loans it was about twenty percent. The tiny market share in local currency loans resulted in part from the restriction on foreign banks' deposit taking.¹⁶ It is forecast that five years after the WTO accession, foreign banks will have fifteen percent of the market share in foreign currency deposits, ten percent market share in local

¹⁴ *Almanac of China's Finance and Banking*, 2000, pp. 548-549.

¹⁵ See 'Impact on China's Sectors after WTO Entry', *Reuters*, 19 September 2000.

¹⁶ John D. Langlois, Jr. 'The WTO and China's Financial System', *China Quarterly* 170 (2001), pp. 610-627.

currency deposits, 20%-30% in foreign currency loans, and fifteen percent in local currency loans.¹⁷

The Potential Benefits of WTO Entry to China's Financial System

Given all the weakness and problems of China's financial system, the concession, which China has made in financial services for its entry to the WTO has surprised almost everyone in the international policy community. Table 1 is a summary of the concession China has promised. If China really keeps its promise of gradually lifting the geographic and business restrictions on foreign financial institutions within five years of accession, the WTO will reward China over the next ten to twenty years, including the flow of more capital to China. Market opening and foreign investment are the focus of the General Agreement on Trade in Services (GATS), as well as the Financial Services Agreement (FSA) under the WTO. Since China's entry promises more market access for foreign financial services firms, it is anticipated that a greater number of international financial institutions will set-up branches or subsidiaries in China after it joins the organization. For example, there are already close to 100 insurance companies waiting for the license to enter the market.¹⁸

Secondly, more foreign investment in the financial sector will bring in more advanced technological and financial products such as online banking, which in last few years has become a basic requirement in the competition for retail banking in the United States. It will surely be introduced to China's banking system soon. Combined with the liquidity increased by the inflow of capital, it will lead to a more efficient allocation of money within China's financial system, which in turn will increase the economy's productivity.

Thirdly, new capital and financial instruments mean more channels for fund raising. This diversification will help to reduce risk in the system. For example, if Chinese citizens have the opportunity to invest some of their money in mutual funds and also to buy insurance policies, rather than depositing all of their savings in a bank, they will be better able to resist the risk of a run

¹⁷ See 'Impact on China's Sectors after WTO Entry', *Reuters*, 19 September 2000.

¹⁸ See Kathy Wilhelm, 'Home Advantage', *Far Eastern Economic Review*, 4 May 2000.

on the bank, than if they 'put all their eggs in the only basket' of the insolvent state-owned banks.

Finally, more foreign participation in the domestic market will add competition to domestic companies and financial institutions. The foreign financial firms will not only compete with domestic companies for market share, but also for talent. Domestic financial institutions must now improve their performance in order to keep their customers, as well as competitive employees.

The Possible Challenges of WTO Entry to China's Financial System

The Asian financial crisis of 1997 was a wake-up call for the Chinese government, making it clear that an unprepared market opening will bring more risk, as well as benefits to the domestic financial system. In response, the Chinese government started to 'clean up the house before the foreign guests really come'. In late 1997, the Central Financial Work Committee was set up in the Party Center to take charge of the task. Thus far, it has done three things to improve the health of the financial system: The PBOC set-up nine trans-provincial branches to replace provincial branches in supervising local banks. This was done in an effort to further reduce intervention by provincial governments in the extension of bank loans. Secondly, the Ministry of Finance issued RMB 270 billion Yuan of special bonds to bolster the capital of the four specialized banks. As mentioned earlier, the large number of non-performing loans and the low levels of capital made these four specialized banks technically insolvent. This capital injection allowed the four big banks to show a positive net worth (2-3% of total assets), although they remained far behind the international standard of capital adequacy, which is 8 % of total assets. Finally, in 1998, four asset management companies (AMCs) – Cinda, Huarong, Changchong, and Dongfang – were created to address the four banks' non-performing loans. In the following two years, 1999 and 2000, the four AMCs issued RMB 1,400 billion of bonds to the four big banks in exchange for their bad loans. This accounted for approximately 20%-40% of the four banks' bad loans.¹⁹

¹⁹ According to official number, the four banks had almost RMB 3,500 billion in bad loans at that time, but the number is doubled if using the international standard of

It is still questionable, however, whether these reform measures have actually improved the health of China's financial system. In the beginning, the AMC arrangement did not work very well. By the end of 2000, it had disposed of only RMB 90 billion, or six percent of the bad loans, which were taken over from the four big banks. The cash recovered from these sales was only RMB 8.3 billion, not enough for the four AMCs to pay their own expenditures. They were ultimately forced to borrow from the central bank to pay the interest on the RMB 1,400 billion bonds. In addition, China's Company Law and Bankruptcy Law favor a companies' managers and workers. As such, the AMCs have been unable to set up new management teams to restructure or liquidate the ailing SOEs. This makes the prospect for bad-loan recovery by the AMCs even gloomier.

If the AMCs remain unable to pay the interest and repayment obligations of the bonds they issued, they could either default or have the Ministry of Finance pay it for them. If they default, it will worsen the four banks' balance sheets by adding an even larger amount of bad loans. If the Ministry of Finance pays, it will deteriorate further the already unsustainable fiscal burden of the government.²⁰ Either way, it will exacerbate rather than improve the health of China's financial system.

There was a another problem being played out at the same time. The state-owned banks were continuing to make extensive loan to the SOEs. The latest numbers show that state-owned banks increased their loans by about twelve percent over last couple of years to a level, which is much higher than the 8 percent growth rate. Only 0.5% of these loans were extended to private

accounting. See Nicholas R. Lardy, 'China's Worsening Debts', *Financial Times*, 22 June 2001.

²⁰ Although the Chinese government maintains that their budget deficit and government debt are very low, the actual number is much higher if bonds, which are issued by the state-owned policy banks and AMCs, are included in last five years, as well as the pension debts, which is still be counted as a liability of SOEs. According to Lardy's estimate, if we take all of these obligations into consideration, the Chinese government's outstanding debt will run as high as 100 percent of its DGP in 2008. It will make the Chinese government's debt position as bad as Indonesia's is today. See Nicholas R. Lardy, 'When Will China's Financial System Meet China's Need?' (Conference paper for Conference on Policy Reform in China, Center for Economic Research and Policy Reform, Stanford University, Stanford, CA, November 18-20, 1999).

enterprises, which represent the most robust players in the economy.²¹ It would appear that, in spite of recent efforts by Chinese financial authorities to make bank officials more responsible for profits and losses, the credit culture has not changed very much. As a result, an increase of RMB 400 billion in bad loan was posted in 2000.²²

As long as the ultimate authority of China's financial system is the Party Center's CFWC and not the PBOC (the central bank), and the Chinese government insists on exploiting the banking system to bail out, rather than reform, state-owned enterprises and welfare programs, the continued accumulation of bad loans in state-owned banks can be expected. If this is the case, these banks will never be ready for the competition, which will come after the WTO accession.

It is quite possible that, even after the WTO, the Chinese government will continue its protection of local banks in a subtle way. For example, it may use internal Party authority to order domestic companies to keep deposits in domestic banks. It can also increase the minimum requirements from new competitors of registered capital and deposits to be made in the central bank. Either way, it will effectively increase the costs to foreign banks of conducting *renminbi* business and will indirectly protect the domestic market.

A similar situation is happening in China's stock markets. As long as the Chinese government refuses to stop considering listings as one of the instruments through which it is able to raise funds for ailing SOEs, the stock markets will continue to operate based on speculation, rather than on investment. Foreign securities firms will continue to focus on underwriting business, instead of fully engaging in the domestic stock markets. If this situation remains unchanged, the anticipated competition and efficiency, which would normally be introduced by foreign investors, will not occur.

Conclusion

In the first twenty years of China's transition, its financial system has played a vital role in maintaining the survival of the state sector. As government budgets

²¹ The figures are calculated from *Almanac of China's Finance and Banking*, 2000, p. 402.

²² Nicholas R. Lardy, 'China's Worsening Debts', *Financial Times*, 22 June 2001.

declined sharply, the existing financial system was able to successfully mobilize domestic savings to finance the investment the state-owned enterprises, and as a result, has helped Chinese policymakers, for better or worse, to postpone the large-scale layoff of state workers. Although this approach to reform has bought time for China to avoid the drastic political and economic changes that most other socialist countries have experienced, it was paid for by its domestic financial institutions. As a result, when China is committed to further integration into the global economy, its financial system will be too weak to compete, yet too important to fail. The next five years are critical as the time will provide the Chinese government with a final opportunity to improve the financial system before foreign competitors obtain national treatment and are thereby able to compete directly with domestic players. The Chinese government should use this time to reduce and eliminate the role of the financial system in financing government's fiscal burdens.

To accomplish this objective, the government must let PBOC, instead of CFWC, be the ultimate regulatory authority for policymaking and supervision of the financial sector. This is the only way in which the Chinese government can alter its own attitude toward the financial sector. The CFWC, composed of members from the Ministry of Finance, State Planning and Development Commission, as well as other government departments, is too inclined to compromise the desperately needed financial sector reforms (as stated below) in favor of other government goals, especially fiscal ones.

Secondly, in order to fundamentally change the credit culture within the big state-owned banks, the Chinese government must stop assigning economically irrational tasks, such as policy lending and treasury bond placement, to the state-owned banks. Moreover, it should let the PBOC, rather than MOF, dictate accounting rules and taxation policies for financial institutions. Only by doing this can the state-owned banks phase out the political functions they continue to play. It must allow state-owned banks to decide for themselves whether to merge or split so it is possible for them to restructure in line with market efficiency.

Thirdly, the Chinese government should immediately terminate the ban on domestic private banks. As many Chinese economists have advocated, the establishment of private banks is crucial for the Chinese financial sector to maintain market share against foreign competition after the WTO accession. It is also important for the economy as a whole to have small and medium-size private enterprises from which to access bank credit and to develop more fully.

This will be especially so after the WTO accession, when China should develop more in line with its comparative advantages (i.e. labor-intensive industries), and the government should further reinforce the role of small and medium-size private enterprises as the growth engine for the economy.²³

Finally, the Chinese government should lift its restrictions on capital flows across different financial markets and liberalize interest rates. Imposing fewer restrictions on the financial system will allow capital to locate more efficiently and thereby improve the profitability and competitiveness of the domestic financial institutions. This will reduce illicit speculations and improve market transparency. In the long run, these elements also represent the preconditions for the PBOC to use market instruments to conduct monetary policy.

If the Chinese government fails to complete more than four tasks in the next five years, the Chinese financial system will continue to be troubled by the government's fiscal burdens, relying on the cash flow provided by the growth of deposits for its survival. When the five-year grace period has expired, even the slightest market expansion by foreign competitors could cause liquidity problems for state banks and lead to a systemic financial crisis. The financial sector will prove to be the weakest link in the coming competition brought on by China's accession to the WTO.

²³ See Lin, Justin Yifu and Li Z., *The China Miracle: Development Strategy and Economic Reform*, Hong Kong: Chinese University Press, 1996, and Lin, J. F., 'WTO Accession and Financial Reform in China', *Cato Journal* 21:1 (Spring/Summer 2001), pp. 13-18.

Table 1. The Concession in Financial Services Which China Made for WTO Entry

Banking	<p>Foreign banks will be able to conduct local currency business with Chinese enterprises starting 2 years after accession.</p> <p>Foreign banks will be able to conduct local currency business with Chinese individuals from 5 years after accession.</p> <p>Foreign banks will have the same rights (national treatment) as Chinese banks within designated geographic areas.</p> <p>Both geographic and customer restrictions will be removed in five years.</p>
Securities	<p>China will permit minority foreign owned joint ventures to engage in fund management on the same terms as Chinese firms.</p> <p>Minority joint ventures will be allowed to underwrite domestic securities issues and underwrite and trade in foreign currency denominated securities (debt and equity).</p> <p>Three years after accession, foreign firms will be allowed 49% stakes in joint ventures.</p>
Insurance	<p>Geographic Limitations: China will eliminate all geographic limitations in 3 years.</p> <p>Scope: China will expand the scope of activities for foreign insurers to include group, health and pension lines of insurance, which represent about 85% of total premiums; phased in over 5 years.</p> <p>Prudential Criteria: China agrees to award licenses solely on the basis of prudential criteria, with no economic needs test or quantitative limits on the number of licenses issued.</p> <p>Investment: China agreed to allow 50% ownership for life insurance. Life insurers may now choose their own joint venture partners. For non-life, China will allow branching or 51% ownership on accession and form wholly owned subsidiaries in 2 years. Reinsurance is completely open upon accession (100%, no restrictions).</p>

The table is based on concessions made by China in agreements reached with the United States in November 1999 and with the European Union in May 2000. Under WTO rules, benefits granted by China to one trading partner are extended to all.