THE TRANSITION OF THE CHINESE BANKING SYSTEM FROM STATE CONTROL TO LIBERALIZATION: A MYTH OR A TRUTH?

- An assessment of the reforms of the large commercial banks and small foreign banks in China from 1978 to 2009

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Abstract

In the last three decades, the Chinese government has gradually opened up its economy and implemented several reforms in a number of industries. However, the reform of the banking system has not kept pace with these industries. In other words, strong control from the state in the banking system remains as the core idea in the Chinese government's financial policy. The degree of financial liberalization in China remains low, despite its membership of and commitments to the WTO. Furthermore, this financial policy is strengthened by the global financial crisis in 2008 which has massively damaged the liberal banking systems in most of the developed countries. This thesis presents these arguments by a comprehensive assessment on the changes on two of the most representative banking sectors – the large commercial banks and small foreign banks – from 1978 to the first season of 2009. In addition, it unveils the strategies employed by the Chinese government to effectively introduce reforms without losing control, and argues that the WTO has had a limited effect on the banking system in China.

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List of Abbreviations

ABC………………………....	The Agricultural Bank of China
BOC……………………….	Bank of China
CCB…..…………………….	The People’s Construction Bank of China
CPC………………………...	The Communist Party of China
ICBC………………………	Industrial and Commercial Bank of China
NPL………………………..	Non-Performing Loan
PBOC……………………...	The People’s Bank of China
RMB…….…………………	Renminibi, the Chinese currency
ROA……………………….	Return on Assets
ROE………………………..	Return on Equity
SOE………………………...	State-Owned Enterprise
WTO……………………….	World Trade Organization

Chapter I – Introduction

In the last three decades, the Chinese government has gradually opened up its economy to the world. However, the speed and progress of economic growth does not correspond with the reform of its financial system. A mature and liberal financial system is missing in China. In other words, long-standing financial control, together with a closed financial system, results in instability, inefficiency, and weakness of the system. Arguably, this obsolete financial system can not meet the demands from the growing market and may be a barrier to further economic growth due to inefficient allocation of the financial resources. Despite pressure from the demands of the market, the Chinese government has only recently started to re-evaluate its financial policy and pay more attention to the development of the financial system, following the Asian Financial Crisis in 1997.

However, up until 2001, the financial system remained underdeveloped and 'bank-based' with most of the financial resources concentrated in the banking system. Furthermore, state intervention in the banking system has been strong, despite the appearance of greater diversity of ownership (Chiu and Lewis 2006). The only truly non-state owned banks are foreign banks, which only accounted for 1.5% of total assets of the whole banking system by 2003 (CBRC 2006). The situation might have been changed with WTO accession that promised more openness and the liberalization of the Chinese banking system. This is because one of the main issues during the negotiations was the further opening up of the banking system to foreign investors. After WTO accession in 2001, China undertook several radical reforms to the banking system to strengthen the stability and the competitiveness of domestic banks, while gradually relaxing the restrictions on foreign banks and investment. At the end of 2006, the Chinese government removed all restrictions on the scope of business and geography of foreign banks, and claimed that it had fulfilled its commitments on fully opening up the banking system to the international financial market.

As China has become an important economy in the world, it is worth understanding the transition of the Chinese banking system which has a significant influence on the world financial market. This thesis, therefore, intends to show the process of transition in the Chinese banking system over the past three decades, in order to understand the changes on the degree of financial liberalization in China. In addition, it further provides insights into the effects of the WTO and Chinese government's financial policy.

1. Research Questions

- What has changed in the banking system, in terms of the degree of financial liberalization, the level of state control, the large commercial banks and foreign banks?

- Has the Chinese government changed its financial policy from one of state control to liberalization? If so, is this driven by the influence of the WTO? If not, what is the policy interpretation to be applied?

2. Methodology

The methodology applied is mainly qualitative, which gives a deeper understanding of the changes to the banking system in China. Some quantitative data will be applied to demonstrate the trend of the development of the banking system over the past three decades and to understand the Chinese government's financial policy. In addition, the *periodization approach* will be utilized to conduct chronological research on the three identified stages with a special focus on two sectors – the large commercial banks and small foreign banks.

Statistical data will be collected from both international and local databases, such as: Bankscope, CEInet Industry Database, the China Statistical Yearbooks published by National Bureau of Statistics of China, the reports published by the China Banking Regulatory Commission and banks, as well as academic articles.

3. Structure

This thesis is composed of four chapters. The first Chapter provides a general overview of this study. In Chapter II, the literature and critics of the Chinese banking system and WTO accession will be discussed in depth. Chapter III, which is the main part of the thesis, offers a contextual narrative of the evolution of the banking system in Chinese from 1978 to the first season of 2009, with particular focus on the two sectors, the large commercial banks and small foreign banks. A large amount of primary material, collected from various newspapers, databases, websites and academic papers, are pieced together in order to show the changes on these two sectors. Chapter IV goes further to provide policy interpretations on the effects of the WTO and the Chinese government's financial policy. Chapter V summarizes the research findings and limitations of this thesis and provides some suggestions for further research.

Chapter II – Literature Review

1. State control over the banking system

From 1978, the Chinese Communist Party Congress decided to focus on economic development rather than political struggle. This decision was followed by a series of reforms over the following three decades, which aimed to relax central government control in order to create more incentives for local governments and the public to boost the economy. The scope of the reforms embraced various aspects such as the financial system, the agriculture sector, the public sectors and state-owned enterprises (SOEs). However, Wang (2003) argues that among all these reforms, the reforms of the financial system are further behind the other sectors. The bank-based financial system is widely believed to be dominated by the state, although several reforms have been implemented since 1978.

The historical trajectory of the reforms in the Chinese financial system since 1978 has been considered in the literature (Qian 2000; Chiu and Lewis 2006). Rather than focusing solely on the financial system, Qian (2000) is keen to investigate the process of China's market transition and argues that it is "better viewed as a path-dependent evolutionary process" (*ibid.*:170). In addition, he also claims that the Chinese government has adopted "second-best arrangements" (*ibid.*:152) instead of the prevailing international best practices. His piece was remarkable at a time when everyone had witnessed an economy that was booming in China but without the existence of democracy in this country. However, his presentation on the Chinese financial and banking system is more descriptive than analytic and it only examines the situation up to 1998.

Chiu and Lewis (2006) distinguish a series of reforms in five stages. At each stage, there is either a significant change in the existing institutions, with a special focus on the role of the People's Bank of China (PBOC), or the establishment of new institutions to develop the financial system. Although Chiu and Lewis recognize some significant accomplishments made by the Chinese government in the past three decades, they argue that governmental control over the financial system has hampered the development of private firms and led to a serious problem of bad loans generated from the inefficient SOEs. This kind of government control is shown in several ways, such as policy lending, political discrimination, and the lengthy process of administration. Arguably, Chiu and Lewis present a clear historical review of the reforms to the financial system, but overlook the improvements of domestic banks after the reforms. Furthermore, some critical indicators on the growth of foreign banks, such as market share of loans, deposits and total assets are missing. These two drawbacks limit the possibility of understanding the real financial policy of the Chinese government hidden behind the reforms.

Allen, Qian J. and Qian M. (2008, thereafter Allen et al.) investigate the role of that the Chinese financial system plays in the economic growth of the country, by examining all aspects of the whole financial system and comparing it with other countries. They argue that the Chinese financial system is still underdeveloped and inefficient because of the unbalanced weight allocated between the banking system, the stock market and the insurance market. In other words, the banking system is relatively more developed than the other of the two, given that those two were newly established in the 1990s. In addition, from the perspective of the structure of ownership, the banking system is dominated by the large commercial banks of which the state is the biggest shareholder.

In addition, by presenting the difficulties generally faced by the private sector when requesting loans from banks, the state control over the banking system is self-evident (Chiu and Lewis 2006; Allen et al. 2008; Li, Meng, Wang, and Zhou 2008, thereafter Li et al.; Ayyagari, Demirguc-Kunt, and Maksimovic 2008, thereafter Ayyagari et al.). Chiu and Lewis (2006) emphasize the strong link between state-owned banks and SOEs makes it more difficult for the private sector to apply for bank loans. Therefore, they argue that the Chinese banking system can not be improved without the improvement of the SOEs. Furthermore, Li et al. (2008) present a more detailed mechanism of the hidden political connection between the banking system and other industries, which discloses the state control over financial resources. They conducted a survey on more than 2,000 private firms and discovered that those firms owned by entrepreneurs who hold membership in the Communist Party of China have an advantage when applying for bank loans.

Some scholars try to further examine the incentives of why the government leaves the development of the financial system behind other domestic industries. Wang (2003) claims that the Chinese government needs a stable financial system which can support the gradual market transition of the other sectors. When fiscal decentralization was introduced to create incentives for local government to boost local economies in the early 1980s, the central government's fiscal power in allocating financial resources (such as transfers) through fiscal channels was inevitably eroded by this policy. To compensate for this loss and to stay in power, the central government shifted its influence from the fiscal sector to the financial system, especially the banking system. With government support, these giant state-owned banks absorbed most of the household savings generated from high economic growth.

To conclude, the literature provides convincing evidence on the explicit or implicit control by the state on the banking system. Nevertheless, a comprehensive study on the changes to the banking system, one which includes WTO accession as an important variable, and especially those changes after 2006, is lacking. By the same token, the current situation of the banking system, in terms of large commercial banks and foreign banks, is missing in the literature. Hence, this thesis intends to fill these gaps in order to understand the Chinese government's financial policy.

2. The WTO commitments and the expectations of WTO accession

It can be agued that the opening up of the banking sector to foreign investors was not a priority for the Chinese government when it applied for membership of the General Agreement on Trade and Tariffs (GATT) in 1986 (after 1995, the GATT was replaced by the WTO). Facing increasing domestic production and discriminated by tariffs imposed by import countries, the Chinese government sought to join GATT so as to remove barriers to its trading activities. Further, from a political consideration, being involved or able to participate in international affairs was also important for China, which had been excluded and isolated from the international arena due to its closed economy and political regime. The negotiations for China's entry to the WTO, however, took fifteen years before agreement was finally reached. During this long and difficult negotiating period, the main counterpart to China was the US, which insisted that China should be classified as a developed country in the WTO and requested that China open up its service industry. Although China managed to protect its classification as a developing country, it had to agree on the request to open up the service industry in order to win the support of the US. In addition, among all the sectors in the service industry, the banking sector was the one of most concern to the US and the European Union, and the removal of all restrictions on foreign banks and investors in this sector by the end of 2006 was requested (PGGP 1999).

Nevertheless, there was a five-year grace period allowing China to gradually lift its restrictions on foreign investors, in terms of geographical restrictions and the scope of business. The first step to loosen restrictions is to fully open up to all types of foreign exchange transactions with foreign clients upon WTO accession. Within one year, foreign banks could deal with foreign transactions with local clients in the four designated costal cities (Shanghai, Shenzhen, Tianjin, and Dalian). The Chinese government committed to add four cities on an annual basis, starting from 2001, and to remove completely the geographical restrictions by the end of 2006. Further, foreign banks could start to conduct local currency business (Renminibi, or RMB) with local enterprises in 2003 and with local individuals in 2006. In sum, the banking sector was expected to be totally open to foreign banks by the end of 2006, which meant that foreign banks would enjoy national treatment and compete with local banks based on the same ground (Bonin and Huang 2002:1078).

It is widely believed that opening up the banking system to international financial institutions would have a significant impact on local banks. The discourses on whether these impacts are positive or negative were at the heart of disputes during entry negotiations. From the positive side, it was believed that foreign competition could stimulate reforms in inefficient domestic banks, and improve transparency and services of the whole banking sector, leading China toward a more market-oriented economy. From the negative side, some scholars and officials considered foreign competition as a threat to the underdeveloped domestic banks. In this regard, Lin (2001) presents a thorough examination of both sides and concludes:

> "Foreign institutions can bring in advanced management skills and business practices…Therefore, the pressure from the WTO accession will be beneficial to the development of China's financial sector, enabling the sector to provide more efficient and convenient services to customers, and benefiting China's overall economic growth" (Lin 2001:17).

> "It is predictable that both the financial institutions and nonfinancial enterprises in China will have a more stable, transparent, and predictable business environment after the WTO accession" (Lin 2001:18).

Lin argues that the monopolistic position of the big four banks would be ended and their nationwide network does not have significant contributions to compete against foreign banks, given that the banking business is more profitable in the major costal regions. Whether domestic banks lose their dominance depends on how much improvement they can make to catch up on the advantages of foreign banks. He further claims that these advantages, such as transparency, techniques, efficiency and various kinds of services will make foreign banks more likely to attract new loans applied by both foreign and domestic customers. However, both of these positive and negative arguments do not touch the core issue lying in the Chinese banking system. Bokros (2009b[1]) argues that the main problem of the Chinese banking system is the strong control by the central government. Arguably, when including this variable into the discourse on the impact of WTO accession, it is worth investigating whether the political interference in the banking system would be reduced because of the commitments made to opening up.

In addition, Qian and Huang (2001) argue that the stability and development of the banking system should be considered as the priority for the Chinese government after WTO accession. They acknowledge the existing underdeveloped banking system and the huge non-performing loans (NPLs) generated by policy lending, which might increase the risk of financial instability from foreign competition. They claim that although there was a clear timeframe to open up the banking system, the expectation and anticipation of oncoming liberalization would make the impact come even earlier. For instance, foreign banks will start their preparation in human resources, networks and researches prior to the final openness in 2006. Hence, they propose several policy recommendations, such as reducing

[1] This argument is extracted from the meeting with Prof. Lajos Bokros on July 2, 2009, Budapest.

the exposure of the banking sectors in the new stock market and increasing the rate of Loan Loss Provision. In addition, the government should create a level playing field for both domestic and foreign banks, which means that domestic banks are not required to provide nationwide services, or that foreign banks should also share some social responsibility by providing services in some remote and underdeveloped regions.

Bonin and Huang's arguments are based on the assumption that the Chinese government acknowledged the short-comings of its domestic banks and that WTO accession merely provided a definite timetable for the financial liberalization of the banking system (Bonin and Huang 2002). In other words, the Chinese government was not unprepared, given that there were some foreign banks which already had the privilege to conduct local currency business with foreign enterprises and individuals on a trial basis in the Pudong District of Shanghai and Shenzhen city before WTO accession (*ibid*.:1082). They predict several consequences as following. First, foreign competition would improve the services of domestic banks and potentially have an impact from the demand side of the interbank market when their business grows in the future. The latter situation may further influence "liberalization of the interest rate, the pricing risk and the development of monetary policy" (*ibid*.:1090) in China. Second, similar to the concerns expressed by Qian and Huang, the big four banks would be in an uncompetitive position due to their political burden in supporting the government's economic policy; whereas foreign banks may heavily concentrate on cream-skimming business, such as plastic money and e-banking services. Fourth, retail banking may also be a field of battle between foreign and domestic banks. Fifth, the above discussed impacts could be either moderate or severe, depending on how the Chinese government and domestic banks use the window of opportunity provided by the grace period, and implement appropriate reforms to accommodate the opening up in 2006. Among these arguments, however, Bokros (2009b[2]) argues that political interference in the big four banks does not mean that they are in a disadvantageous position when competing with foreign banks. On the contrary, this is an advantage for the big four banks. He claims that, due to the importance and the size of the big four banks, they are tacitly guaranteed against bankruptcy, regardless of how inefficient they are and how big their losses are.

To conclude, these literature discussing the commitments and possible impact of WTO accession present not only the banking system as it was in 2001, but also the conflicting thoughts in China. On the one hand, China expected the benefits that foreign competition might bring into an obsolete banking system. One the other hand, it was afraid of that foreign competition might overwhelm the local banking system. However, seven years after WTO accession, a systematic analysis on whether the hopes and worries materialized in reality is missing. Hence, it is the intention of this thesis to serve as a preliminary study in this regard.

[2] This argument is extracted from the meeting with Prof. Lajos Bokros on July 2, 2009, Budapest.

Chapter III – An Assessment of the historical path of the reforms of the large commercial banks and small foreign banks from 1978 to 2009

The Chinese banking system is generally known to be composed of three formal sectors – the central bank, the three policy banks[3] and a variety of commercial banks. The first two are not the subject of this thesis because their mission is tied to the government's macroeconomic policies and they are not involved in private economic or commercial activities.

The latter – commercial banks – will be the subject in the following content, in particular, the large commercial banks (hereafter, the big four banks[4]) and foreign banks. The author acknowledges that the commercial banking system in China consists of various kinds of actors, such as the big four banks, joint stock commercial banks, rural and urban cooperatives, foreign banks, and even informal financial institutions. However, the author is not able to examine all of these actors, due to time constraints and the availability of statistical data. Arguably, since the big four banks have always been the main actors due to their overwhelming amount of total assets, their changes can serve as a proxy to understand the Chinese government's financial policy. Moreover, as previous literature review has shown, WTO accession is widely believed to have had a significant influence on the

[3] This three policy banks are, The Agricultural Development Bank of China, the Export-Import Bank of China, China Development. Each bank is in charge of different field of policy lending, such as agricultures, trade, and general investment and infrastructure.

[4] These large commercial banks are widely referred to the big four state-owned banks. These big four banks are Bank of China (BOC), the Agricultural Bank of China (ABC), the People's Construction Bank of China (CCB), the Industrial and Commercial Bank of China (ICBC).

Chinese banking system because the Chinese government made several commitments to open up access to foreign investors. Therefore, to choose foreign banks and foreign investment, and investigate the changes on them, can be helpful to understand the path of financial liberalization in the Chinese banking system as well as the effects of the WTO.

The structure of this chapter is divided into three stages, based on the timeframe of the WTO commitments. The first part covers 1978 to 2001. This part will provide a history of the slow reforms of the big four banks and the foreign banks. The second part covers 2002 to 2006. This part is in line with the grace period following WTO accession. During this period, the big four banks experienced radical and speedy reforms whereas foreign banks were preparing to invest in China. The third part covers 2006 till the first season of 2009. It presents the situation of the big four banks and foreign banks after 2006 when all the restrictions on the scope of business and geography were abandoned. Moreover, it includes the 2008 global financial crisis to analyze the changes of these two sectors at the current stage.

1 From 1978-2001

1.1 The big four banks

From 1979 to 2001, much effort had been made to transform the mono-banking system into a diversified banking system, such as the creation of separate banking institutions, the approval of private commercial banks and a few foreign banks with a restricted scope of business (Chiu and Lewis 2006). Despite this effort, the problem of inefficiency remained as one of the core issues within the banking system. This can be seen in the fact that the diversification did not lead to the decreasing control by the state. More specifically, the process of diversification only turned the PBOC from an overarching mono-bank into a partially independent central bank (*ibid.*), and at the same time, established three policy banks and other commercial banks to take over the business affairs from the PBOC.

By the end of 2001, the big four banks remained dominant in the Chinese banking system. The most obvious evidence can be found by examining the level of concentration of the whole banking system. Lee (2005:32) claims that, the big-four banks accounted for 83.56% of aggregate assets, for 72.22% of aggregate capital, for 67.69% of aggregate deposits and for 68.84% of aggregate loans, and they can be classified as a Type II Oligopoly, according to J. Bain's model. These figures show the extreme concentrated nature of the banking system with more than 65% financial resources held by the big four banks. Moreover, their scale of business was not equivalent to their abilities of operation, profitability and efficiency (Wu 2002). This is due to the communist political regime, where the state-owned banks were committed to conduct policy lending corresponding to governmental policy. Most of the time, these banks issued loans to inefficient SOEs, which resulted in a large amount of NPLs. In addition, these NPLs increased year on year.

It can be argued that the 1997 Asian Financial Crisis triggered the Chinese government's determination to seriously consider the problem of the NPLs and the stability of the financial system. Since 1998, the reforms in the financial sector shifted its aim from diversifying financial institutions to assuring the stability of state-owned banks and sufficient supervision of financial institutions[5]. First, from the aspect of regulation, the government replaced the credit quota system with international standards such as capital adequacy and deposit-to-loan ratios, and requested that the big four banks take responsibility when conducting their lending business. Second, from the point of view of

[5] In November 1997, the Chinese government held a national meeting to discuss the issue of the financial system. Three principles of the meeting were "strengthen financial reforms, rectify the order of financial system, and prevent financial risk" (Wu 1999:40).

problem solving, the government took several measures to solve the problem of NPLs (Chiu and Lewis 2006:199). The Ministry of Finance issued special government bonds, valued at 270 billion RMB, to increase the capital adequacy ratio (CAR) of the big four banks in 1998. Later, four asset management companies were established to gradually liquid these NPLs, valued at 1.4 trillion RMB. Nevertheless, although some progress had been shown, the previous legacies were too serious to be solved within a short period of time. By the end of 2001, only one of the big four banks met the international standards on CAR, and the aggregate ratio of the NPLs in China remained the highest at 16.9% (which accounted for 22.7% of the total GDP in China) among all of the key Asian countries[6].

1.2 Foreign banks and foreign investment

It can be claimed that, before WTO accession, opening up the banking system to foreign banks and investors was merely a supplementary clause to a whole series of market transition reforms. During the process of economic development, the Chinese government faced a dilemma of the level of openness. There was no win-win strategy to attract foreign investment without opening up its banking sector to foreign banks. More specifically, foreign banks could hasten the speed of attracting foreign investment by providing services to foreign investors who wanted to invest or conduct business in China. However, the dilemma came from the hesitation of the weak domestic banks which were widely believed to be unable to face stiff competition once the market was opened to foreign banks. For instance, in case the big four banks lose their dominance in the allocation of financial resources, the SOEs would be in danger, leading to social and political problems, such as high unemployment and political protest. Hence, it was neither in the interest of the state,

[6] Data collected from Wu (2002:5) and Allen, Jun Qian and Meijun Qian (2005:35). In addition, the key Asian countries refer to Hong Kong (4.9 %), India (4.6 %), Indonesia (9.9 %), Japan (9.2 %), South Korea (3.4 %) and Taiwan (6.2 %).

nor the higher officials to quickly open up access to foreign financial institutions. With high skepticism and cautiousness, opening up the banking sector was not a priority of the Chinese government, but merely a necessary trade-off in order to attract foreign investment. Before entering the WTO, there were many restrictions and a limited quota for foreign banks to be approved to operate in China, restrictions including no permission to conduct RMB business and local deposits business. Chiu and Lewis (2006) claim that these privileged foreign banks could only establish direct branches, not companies, and their business was mostly restricted within the network of foreign firms or joint venture. Arguably, for the Chinese government, by means of isolating foreign banks from the locals, it could protect the immature and weak domestic banks and meet the purpose of attracting foreign investment. By the end of 2002, the total assets of foreign banks accounted for only 1.7 %[7] in the whole banking system, although the first foreign bank dated back to 1980 (Lien 2008).

To conclude, the overall situation of the big four banks, before the end of 2001, was at the outset one of transforming into more dependent and profitable commercial banks. Given the historical legacies, however, the reforms did not make significant progress, and led to the following radical and intensive reforms during the grace period before further opening up the banking system in 2006. In addition, foreign banks in China were under a large number of restrictions at this stage. Lastly, based on the difficult experience of collecting statistical data during this period[8], it can be argued that the lack of accountability, bad governance and inefficiency of the state-owned banks remained unsolved after two decades of reforms.

[7] The data is consolidated from the table 14.4a appeared in Allen, J. Qian and M. Qian (2008).
[8] It is understandable that the data before the 1990s are incomplete or missing. However, even most of the data in the early 21st century, such as the data from 2000 to 2002 are not capable of being collected for comprehensive analysis. This evidence shows that previous reforms were ineffective at improving the internal governance of state-owned banks.

2 From 2002-2006

2.1 The big four banks

Although WTO negotiations took at least fifteen years, both the government and the public were aware that China would eventually enter the WTO. Therefore, since the Chinese government started to apply for its membership in the WTO, the whole nation had been undergoing several reforms in order to be prepared for the date of WTO accession. Nevertheless, as seen in the previous section, the outcomes of the previous reforms of the big four banks were not remarkable. Thus, more intensive and critical reforms were introduced after China's entry was confirmed by the WTO. These reforms were centered on the goals of reconstructing the big four banks into modern commercial banks with the characteristics of "a complete structure of internal governance, a healthy mechanism of operation, a clear vision, sound in financial status, and strong competitiveness in the international environment" (Wu 2002:6).

Apart from continuing to solve the NPLs, the key strategy implemented during this period was to transform the big four banks into publicly listed and traded companies. It can be argued that this series of reforms was more radical and deep than the ones before 2002. It not only touched the structure and ownership of these banks, but also the mentality of the staff of these banks, which were considered as the core and difficult parts of the reform.

> "The most difficult issues are the change of mentality and the structure. In addition, personnel are the key variable in this regard" (Xiao Gang, Chairman of the BOC, cited in *Xinhuanet* 2004).

> "To change the mentality of the personnel and improve the overall quality of human resources are the biggest problems. There is neither business concept nor healthy structure. Internal governance is seriously handicapped with no risk control and no effective operational mechanism" (Zhang En Zhao, Chairman of the CCB, cited in *Xinhuanet* 2004).

To achieve the goal, the State Council introduced a strategy with four steps – capital injection, becoming a listed company, reconstructing the ownership by welcoming foreign partners, and initial public offering (IPO). Furthermore, a new banking supervision entity – The Chinese Banking Regulatory Committee[9] (CBRC) – was established in early 2003, which immediately introduced a 'policy of foreign strategic investment' to encourage investment from foreign financial institutions. This policy relaxed the cap on the equity share allowed to a single foreign investor in an existing domestic bank, with the proviso that the equity share of total foreign investment can not exceed 25%[10].

By means of these policies, a series of reforms was implemented. The Chinese government firstly poured one tenth of the national foreign reserves (22.5 billion USD) on the BOC and CCB at the end of 2003, followed by the second wave of capital injection (15 billion USD) on the ICBC in 2005. Each of the three banks, after capital injection, was transformed as a listed limited company, and then started to undertake negotiations with foreign investors for future joint partnership. During the year 2005-2006, several large foreign financial institutions, such as the Bank of America, the Royal Bank of Scotland and Goldman Sachs, were invested in the BOC, CCB and ICBC. Among them, the BOC sold 21.6% of its shareholding, followed by the CCB's 14.1% and ICBC's 10% (Chiu and Lewis 2006:202; Lien 2008:395). Figure 3-1 shows to whom and to what extent that the three banks sold their shareholding.

[9] The CBRC is a specialized public sector which is responsible for the financial and banking affairs. Key affairs include establishing regulations, approving entry applications of the new banks, and supervising activities of the banks. (Source: CBRC Website)

[10] After the CBRC was established in 2003, it immediately introduced a regulation: 'Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions' (CBRC 2003). This regulation was under the command of the State Council and was made to encourage foreign financial institutions to invest in the Chinese-invested banks. For a single foreign bank, it is allowed to hold up to 20% equity share in a Chinese-invested bank (used to be 15%). For the joint foreign banks, it is up to 25%. This policy is also referred as the 'Foreign Strategic Investment Policy'.

Figure 3-1: The implementation of foreign strategic investment in the CCB, BOC and ICBE in 2005 and 2006

	Foreign shareholders	Ratio of the foreign shareholders in the bank	Time
CCB	Bank of America Temasek Holdings of Singapore	8 % 5.1 %	June 2005
BOC	Royal Bank of Scotland Merrill Lynch Hong Kong Li Ka-Shing Temasek Holdings of Singapore UBS	10 % 10 % 1.6 %	August 2005
ICBC	Goldman Sachs American Express Allianz	10 %	February 2006

Source: Chiu and Lewis (2006:202), Lien (2008:395)

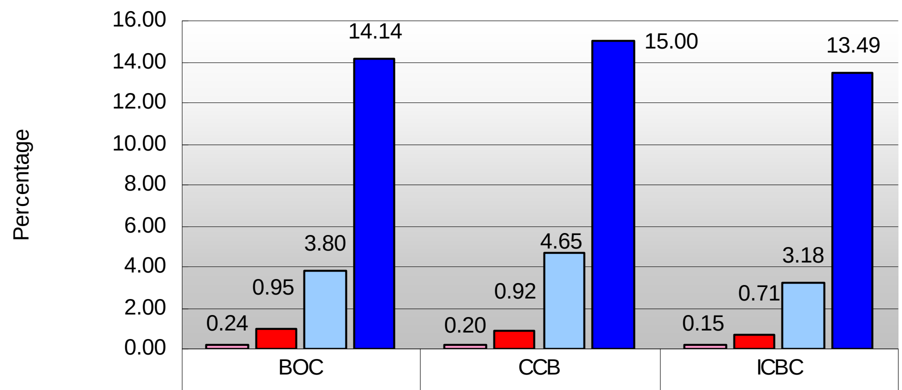
After the three banks were reconstructed into a multi-ownership entity by allowing foreign partners to buy shares, the next step was the initial public offering. By the end of 2006, the three banks went public on the Hong Kong Stock Exchange, and the ICBC also went public on the Shanghai Stock Exchange. Thus, the big three banks were no longer solely owned by the state and their organizational structures were transformed into western style of commercial banks.

Although the scale and depth of these reforms were no less than previous reforms, the speed of preparation and implementation was far faster. It only took five years for the big three banks to conduct this series of reforms. This situation can be explained by the pressure of approaching foreign competition after the five-year grace period and the determination of the higher officials in China.

"For China, this series of financial reforms is a critical war (Bei Shui Yi Zhan). We have to win the battle, so we have to pay full attention to make it succeed. Our economy is currently at a cross roads. If we adjust to it well, we can sail through smoothly. If not, however, we will have problems" (Premier Wen Jia-Bao, cited in *Xinhuanet* 2004).

To conclude, during the grace period, China was under a series of radical reforms of the big four banks. The Chinese government had made much effort on transforming three of them into modern publicly listed and traded commercial banks. By the end of 2006, the performance of the three banks had been improved significantly. Both of their return on assets (ROA) and return on equity (ROE) increased about four times when compared to 2001 (Figure 3-2). In addition, both the ratio of NPLs and the amount of NPLs decreased remarkably. For example, the amount of NPLs of the BOC decreased by 88% and the ratio of NPLs dropped from 26.72% to 4.04% (Figure 3-3). Hence, it can be argued that the progress of banking reforms during this stage was much more efficient and deeper than the previous stage.

Figure 3-2: The performance of the BOC, CCB and ICBC



	BOC	CCB	ICBC
ROA 2001	0.24	0.20	0.15
ROA 2006	0.95	0.92	0.71
ROE 2001	3.80	4.65	3.18
ROE 2006	14.14	15.00	13.49

Source: Bankscope in 2001 and 2006

Figure 3-3: The amount and the ratio of the NPLs in 2001 and 2006

	Amount of NPLs (Million RMB)		Ratio of NPLs (%)	
	2001	**2006**	**2001**	**2006**
BOC	436,020	98,220	26.72 %	4.04 %
CCB	291,393	94,399	18.98 %	3.28 %
ICBC	791,989	137,745	29.45 %	3.79 %

Source: Bankscope in 2001 and 2006

2.2 Foreign banks and foreign investment

From 2002 to 2006, this grace period provided the Chinese government time to implement more reforms to its domestic banks and arrange sufficient regulations on foreign banks. Arguably, it was a very critical period for China to quickly strengthen and improve its banking system before the oncoming competition from foreign banks. Furthermore, the stage-by-stage opening up can be seen as a learning process for domestic banks to gradually adapt to international practices.

The overall situation of the foreign banks during the grace period can be described from two aspects. First is the investment environment, and the second is the development of foreign banks at this stage. Starting form the investment environment, it is strongly linked to the level of control from the government. Despite WTO commitments, the real practices were based on the new regulations and laws enacted to regulate foreign banks after WTO accession. For instance, at the end of 2001, the State Council enacted new 'Regulations of the People's Republic of China on Administration of Foreign - funded Financial Institutions' to replace the previous one made in 1994 (The State Council 2001). Arguably, the most remarkable improvement of the new regulation was in the business scope. Article 17 indicated that foreign banks can receive deposits from the public, issue short, middle and long term loans, and conduct bankcard business. Nevertheless, the expansion of the scope of business did not come without any proviso which became the hurdle for foreign banks. For example, Article 2 indicated minimum capital requirements which were extremely high compared to international standards (WTO 2004), and Article 20 set three requirements for the application of conducting RMB business[11]. These requirements imposed barriers to entry which was considered as the implicit restrictions made by the Chinese government in order to impede the likely significant growth of foreign banks in China.

Second, the development of foreign banks can be presented by various kinds of indicators, such as the number of approvals, market share, total assets and the ratio of growth. By the end of 2006, there were 115 foreign banks that had approval to conduct RMB business, and the total assets of foreign banks accounted for 2.11% in the Chinese banking system (CBRC 2006). Figure 3-4 shows that both the total assets and the percentage of their market share have increased since 2003, which meets the general expectation. However, both of the growth rates of the total assets (22.87%) and market share (3.8%) decreased rapidly in 2005, when compared to the rates of 2004 (40% and 22.67% respectively). According to the five-year timeframe, it was expected that the growth of foreign banks should be progressively increasing because of the gradual removal of restrictions. The statistics, however, present a different story. Arguably, these decreasing rates are likely to be explained by the fact that foreign investors were more interested in becoming shareholders in existing domestic banks. A report published by the PBOC (2006) demonstrated that there

[11] These three requirements are, first, that the applicant should have operated in China for at least three years. Second, the applicant should continually have revenues in the latest two years. Third, the applicant should meet the requirements of the PBOC. Furthermore, the third requirement is not clearly defined, which leaves an ambiguous area for some political maneuvering. That is, the destiny of the foreign applicants basically depends on the decision of the PBOC which is still not fully independent from central government.

were twenty-five foreign banks that had invested in twenty domestic banks by 2005. More importantly, three of the big four banks sold their shareholding to foreign investors[12]. The BOC, for example, sold 21.6% of its shareholding, which was equivalent to 3.2 % of the total assets in the whole banking system at that time. By the end of 2005, when foreign banks' market share of the total assets was only 1.91%, they expanded their total assets rapidly through the policy of foreign strategic investment encouraged by the Chinese government. This situation inevitably slowed down the speed of expansion of the assets of foreign banks.

Figure 3-4: The development of foreign banks in China from 2003 to 2006

	2003	**2004**	**2005**	**2006**
Total Assets (Billion RMB)	415.9	582.3	715.5	927.9
Rate of the growth of total assets	N/A	40 %	22.87 %	29.68 %
Market share (total assets %)	1.5 %	1.84 %	1.91 %	2.11 %
Rate of growth of market share (%)	N/A	22.67 %	3.8 %	10.47%

Source: CBRC (2006)

To elaborate further, the policy of foreign strategic investment effectively created incentives for foreign banks to join this policy rather than operating their own banks, given that there was massive amount invested in the big four banks. Bokros (2009a[13]) argues that the only goal of the foreign banks is to earn profits. Therefore, being included in the monopoly system ensures the opportunity to maximize profits. As long as the dominant ownership in the big four banks is held by the state, foreign banks would prefer to cooperate rather than compete because there is no risk of bankruptcy which is the safest and most profitable

[12] Please refer to page 19.
[13] This argument is extracted from the meeting with Prof. Lajos Bokros on January 23, 2009, Budapest.

investment. Furthermore, it can also be claimed that, for foreign banks, investing in domestic banks not only saves a lengthy application, but also takes advantage of the existing networks of domestic banks, such as the widespread number of branches which can contribute towards the credit card business in the near future, or the political links that domestic banks can provide. Thus, as the political interference in the banking system is still intact, buying shares in domestics banks, especially the big four banks seems to be a profit-guaranteed investment, and a less costly way to gain profits and market share.

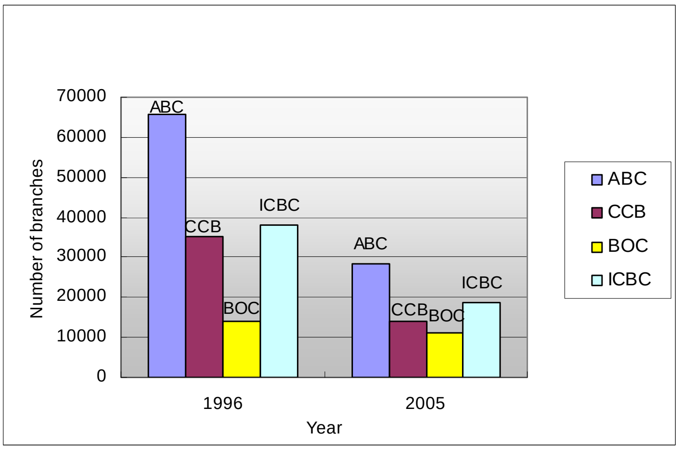
3 From 2007 -2009

3.1 The big four banks

By the end of 2006, only the Agricultural Bank of China (ABC) remained a fully state-owned bank, although it had submitted its first proposal for reform in 2003, followed by revised proposals in 2004 and 2005. However, these proposals were never approved by the State Council due to severe disputes on the direction of the reform in the ABC. The ABC was considered to be the most difficult one among the four, owing to its dual characteristics – the main financial resources in the rural area, and one of the large state-owned banks (*People Daily* 2006). Farmers make up most of the population in China and they were pioneers in the economic reforms in China since 1978 (Qian 2000). Therefore, reform of the ABC should be planned and implemented carefully. Should the reform fail, it would affect at least 737 million people, or 56% of the total population (NBSC 2008). Arguably, this would cause not only social and economic problems but also, more importantly, political problems which are the least the government would like to face. Therefore, reform of the ABC was suspended until several reforms to the three big banks were implemented well.

Encouraged by previous success, the State Council finally passed the policy of transforming the ABC into a shareholding bank in October 2008 and this policy was implemented in January 2009. Nevertheless, unlike the others, the ABC was not approved to welcome foreign partners so the state remains the only shareholder of the ABC. According to its annual report 2008 (ABC 2008), there was no mention of introducing foreign investors to help improve the internal governance of the bank in the next ten years. This information serves as an implicit signal of the political consideration of the state. That is, the Chinese government has no intention to relinquish its absolute control over the ABC which is the most widespread national bank, and has always had the most branches or offices in China (Figure 3-5). In addition, it is not in the state's interest to allow rural people to be exposed to foreign cultures which may likely lead to unexpected results, such as being enlightened by liberal and democratic concepts[14].

Figure 3-5: The number of branches of the big four banks

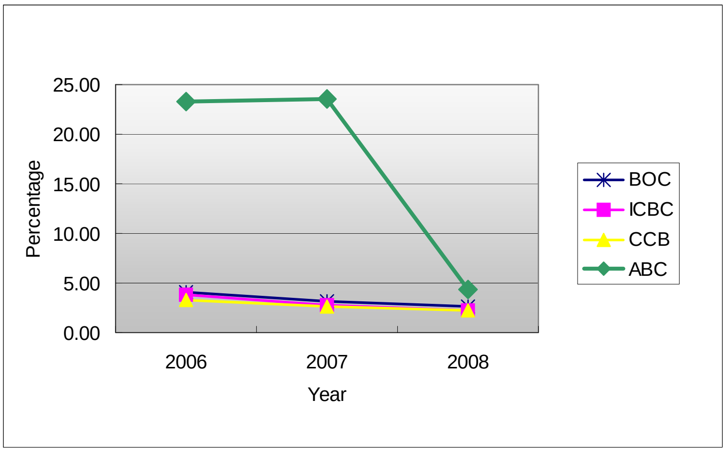


Source: CEInet Industry Database in 1996 and 2005

[14] Although the economy in China has rapidly developed, there is not so much change in most of the rural areas. This argument comes from a conversation with a foreign student studying in China who claims that they are not allowed to find apartments by themselves and are 'advised' not to have too much interaction with local people.

After all this reconstruction and public listing, it is expected that the performance of these big four banks would be more market-oriented and efficient. Figure 3-6 shows that the ratio of NPLs of each of the four banks has continually declined, which can be interpreted as an improvement in the asset quality. In addition, Figure 3-7 presents the ratio of ROA and ROE of the three of the big four banks. Among them, the CCB and ICBC have been publicly listed and sold shareholding to foreign partners, and their ROA and ROE show an upwards trend, which means that the performance continually improved. According to the annual report of the CBRC (2008), it claimed that the reforms of the big four banks have been implemented well and will be continued in order to be more competitive in the international financial arena.

Figure 3-6: The ratio of NPLs in the big four banks



Source: ABC (2008), BOC (2008), CCB (2008), ICBC (2008)

Figure 3-7: The performance of the BOC, ICBC and CCB from 2006 to 2008

		2006	2007	2008
BOC	**ROA**	0.95	1.09	1
	ROE	14.19	14.22	13.72
ICBC	**ROA**	0.71	1.02	1.21
	ROE	15.37	16.23	19.43
CCB	**ROA**	0.92	1.15	1.31
	ROE	15.00	19.50	20.68

Source: BOC (2008), CCB (2008), ICBC (2008)

3.2 Foreign banks and foreign investment

China committed itself to lifting all the restrictions on foreign banks after a period of grace. In November 2006, the Chinese government enacted a new regulation, 'Regulations on the Administration of Foreign-funded Banks of the People's Republic of China' which is regarded as a big step for China, in terms of the degree of financial liberalization, the fulfillment of WTO commitments and a more comprehensive standard of supervision (CBRC 2006). Ba[15] (cited in *Financial News* 2006) argues that the new regulation is a combination of liberalization and protection, as well as a combination of localization and internationalization. He claims that the most remarkable difference in this regulation is that it draws upon international experience and completely separates the responsibility and rights between locally listed foreign banks and direct branches of the foreign banks (which are listed in their home countries). Foreign banks can conduct RMB business and issue credit cards, with the proviso that this bank should be listed for three years and be continually profitable for two years. Nevertheless, direct branches of the foreign banks can only conduct RMB business based on a case-by-base application, and the amount and terms of deposits are limited. According to the Chinese government, the latter is not under the

[15] Ba Shu-Song is the Deputy of the Research Institute of Finance under the Development Research Center of the State Council.

supervision of the CBRC, which may have the potential to damage the stability of the banking system. Therefore, it is necessary to distinguish the different characteristics of the two and provide reasonable regulations on them.

Regarding the situation of foreign banks, after the Chinese government lifted the restrictions on geography and scope of business, giving foreign banks national treatment, there has been a growth in foreign banks. First, at the end of 2008, the total assets of foreign banks amounted to 1,344.8 billion RMB, which is almost 45% more than 2006, and the market share increased by 0.05% (Figure 3-8). Second, the business of issuing loans and receiving deposits also showed rapid growth. At the end of 2008, the foreign banks' deposits amounted to 533.5 billion RMB, 2.19 times more than 2006. The amount of loans was 661.7 billion RMB, 1.55 times more than 2006 (Figure 3-9). When investigating the market share of both loans and deposits, Figure 3-10 shows a big jump in 2007. The market share of loans and deposits of foreign banks had increased from 2.44% to 3.33% and from 0.83% to 1.16%, respectively. Therefore, it can be argued that the expansion of foreign banks has become more rapid and fierce after the Chinese government lifted its restrictions on the scope of business and geography.

Figure 3-8: The market share of total assets of foreign banks in China from 2006 to 2008

	2006	2007	2008
Total Assets (Billion RMB)	927.9	1,252.5	1,344.8
Rate of growth of total assets	29.68 %	34.98 %	7.37 %
Market share (total assets %)	2.11 %	2.38 %	2.16 %
Rate of growth of market share (%)	10.47%	12.80 %	- 9.24 %

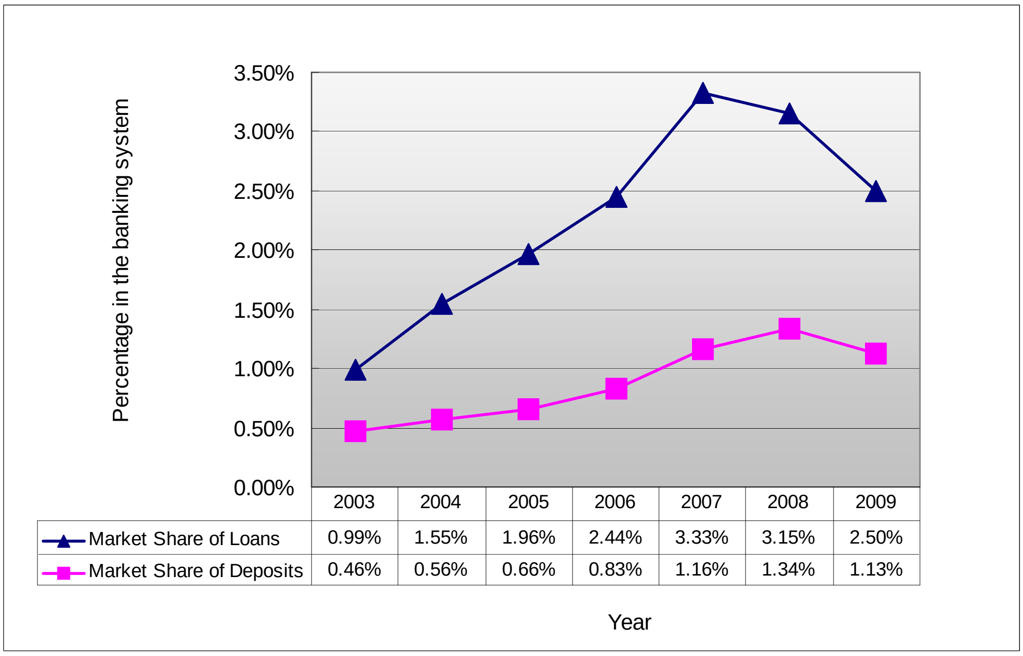
Source: CBRC (2008)

Figure 3-9: The amount of deposits and loans of foreign banks from 2006 to March 2009

	2006	2007	2008	2009.3
Deposits (Billion RMB)	244.1	390	533.5	502
Rate of growth of deposits	N/A	60 %	37 %	- 6 %
Loans (Billion RMB)	427.9	623.5	661.7	613.9
Rate of growth of loans	N/A	46 %	6 %	- 7 %

Source: CEInet Industry Database from 2006 to March 2009

Figure 3-10: Foreign Banks - market share of deposits and loans from 2001 to March 2009



Source: CEInet Industry Database from 2003 to March 2009

Some statistics after 2007, however, present conflicting results which do not correspond to the arguments mentioned above. Firstly, the growth rate of total assets in 2008 slowed down to 7.37%, which was only one-fifth when compared to the 34.98% figure in 2007 (Figure 3-8). Hence, the market share shrunk back to 2.16 %. Secondly, the growth rate of deposits between 2007 and 2008 decreased from 60% to 37%. The growth rate of loans also decreased from 46% to 6%. Further, both rates turned negative during the first season of 2009 (Figure 3-9) Third, Figure 3-10 demonstrates the market share of loans started to have its first reverse in 2008, and the slope of decline is deeper in the first season of 2009. By the same token, the market share of deposits also showed a decline in the first season of 2009. This retreat can be explained by the global financial crisis triggered in September 2008. These foreign banks, although listed in China, could not avoid the influence from their parent companies. Although foreign banks in China had been expanding more rapidly during the last seven years than before 2001, their market share of deposits was still in its infancy. Thus, to conduct further expansion, they needed capital from their parent companies instead of deposits from the Chinese households. While many international financial institutions were badly affected by the global financial crisis and their assets shrunk rapidly due to this crisis, they were not able to pour large amounts of financial resources to their subsidiary companies for further expansion. The growth rate of the subsidiary companies, therefore, retreated. Nevertheless, while most of the countries in the world were heavily hit by this crisis, China has become a more attractive environment for foreign banks because China is less exposed to the risk of financial innovations. This can be seen in the amount of total assets of foreign banks, which was still increasing in 2008, although more slowly owing to the insufficient support from their parent companies (Figure 3-8).

Lastly, the policy of foreign strategic investment has been continually encouraged by the government. The CBRC (2008) argues that this policy has successfully attracted 32.8 billion USD from foreign investors since 2002. According to the regulations from the CBRC, foreign investors have to hold these shares for at least three years before selling them. For the Chinese government and domestic banks, this three-year holding period avoids short-term opportunists damaging the stability of the financial system. From the end of 2008, however, many key foreign investors such as the American Express, UBS, the Bank of America and Goldman Sachs, started to sell all or part of their shares. The latest significant incident is the Bank of America deciding to sell their 13.5 billion shares in the CCB, valued at 6% of the total CCB shareholding, in order to attain liquidity (*Wen Wei Po HK* 2009). The prevailing discourse in China has centered on the unexpected global financial crisis in 2008 which is also the year that a number of large foreign strategic partners were free to sell their equities. In order to save their parent companies, these foreign banks had no choice but to sell their shares to increase liquidity. Arguably, this discourse can not fully explain the situation. It can be claimed that, after three-year investment, foreign investors realized that there is no possibility for them to significantly influence the state-owned banks under the equity share cap. Hence, especially those companies who invested in the big-four banks, decided to retreat from this field.

Chapter IV: Breaking the myth – the effects of the WTO and insights into Chinese financial policy

In the previous Chapter, the changes to the big four banks and small foreign banks from 1978 to the first season of 2009 were presented. The overall observation is that, although several intensive reforms have been implemented in recent years, there has been no remarkable change on the market share of the two banking sectors. In other words, the dominant position of the big four banks remains unchallengeable, and the influence of small foreign banks is still marginal. Furthermore, since the central government is the major shareholder of the big four banks, the whole banking system has not gone beyond the control from the state. This implies that the degree of financial liberalization in China is lower than has generally been believed. Hence, the more optimistic hopes and pessimistic concerns of the possible influence of WTO accession appear to be unfounded. It is highly doubtful that the banking system in China has become a more liberal market, easily accessible and fully open to different actors all over the world.

In this regard, the following will focus on the policy interpretations which are drawn from the outcomes of the previous banking reforms in the big four banks and small foreign banks and investment. These interpretations are expected to provide a deep understanding of the essence of the current banking system and financial policies in this country.

1. The limited effects of the WTO

Starting from the effects of the WTO is one of the ways to understand the degree of financial liberalization in China. As discussed in Chapter II, WTO accession brought a number of disputes on the possible effects on the Chinese banking system. Arguably, after evaluating the banking reforms in Chapter III, WTO accession does have positive influences on financial liberalization in China, although these influences are limited. This argument stems from two aspects. The first is that the policy interpretations from the time and contents of the new regulations which were enacted following WTO accession, and the second is the situation of foreign banks in the Chinese banking system.

First, most of the essential regulations related to foreign financial institutions were introduced at the time immediately before each opening up point. For instance, the 'Regulations of the People's Republic of China on Administration of Foreign-funded Financial Institutions' was enacted at the end of 2002, and the 'Regulations on the Administration of Foreign-funded Banks of the People's Republic of China' was made at the end of 2006. These regulations are regarded as the preparations made by the Chinese government in order to fulfill its WTO commitments. Arguably, the 'introduction of legal regulations for the banking system' serves as an effective marketing means to the media and other WTO members. The previous outstanding economic growth motivates China to seek a higher level of recognition and to be a more active participant in the international society. Therefore, joining the WTO is not only based on its economic interests but also political interests, and the Chinese government, at least on the surface, shows its political will to comply with the WTO commitments by introducing several regulations at certain critical times, for the purpose of its reputation in the media and international arena.

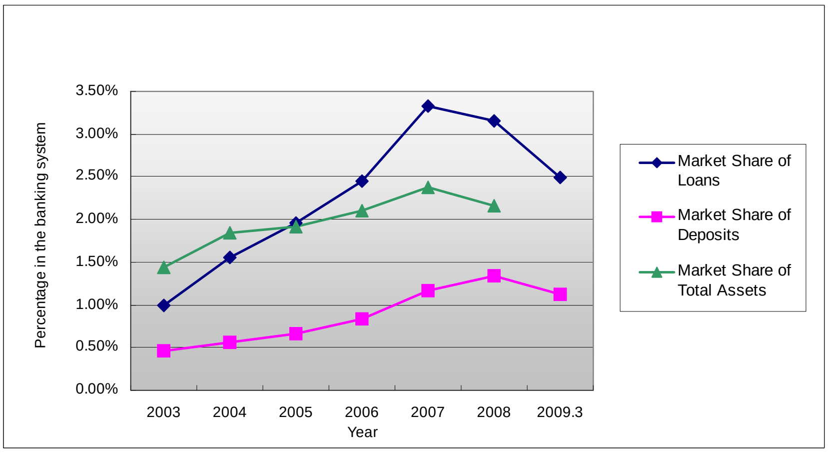
However, the contents of these regulations present a conflicting story of the degree of compliance from the Chinese government. That is, the implicit barriers hidden behind these regulations show that free market access is still withheld from foreign banks, and is evidence of the limited influence of the WTO. According to the latest transitional review held by the Committee on Trade in Financial Service of the WTO at the end of 2008, both the US and the EU were concerned about several unresolved issues[16] which had already been raised in previous transitional reviews. For the US and the EU, these issues are considered as effective barriers that impede the market access by foreign banks. However, the Chinese government never shared the same views. Instead, it has always claimed that these issues are either beyond its WTO commitments, or based on prudential principles in order to "maintain the soundness and stability of domestic financial systems" (WTO 2006:4). Thus, although new legal regulations have been introduced after WTO accession, the most important issue – market access for foreign banks – is still at the heart of disputes between the Chinese government and other WTO members. This further proves the limitation of the WTO, in terms of its power in forcing the Chinese government to liberalize its banking system. Therefore, the effects of the WTO appear to be not as significant as expected.

Second, the earlier demonstration of the growth of foreign banks and investment (Figure 4-1), and the improvement of the big four banks in terms of their structure of ownership, assets quality and operation performance, has proved that some process of financial liberalization has been undertaken in China. Further, the decreasing market share of the big four banks in the banking system also supports the above argument (Figure 4-2). These changes are led by the relaxation of the restrictions on the scope of business and geography.

[16] These questions include the foreign ownership cap for existing Chinese domestic banks, the extremely high minimum working capital requirements for direct branches of foreign banks which limit market access for foreign banks, and the more restrictive requirements to the branches of the foreign banks (WTO 2008a; WTO 2008b).

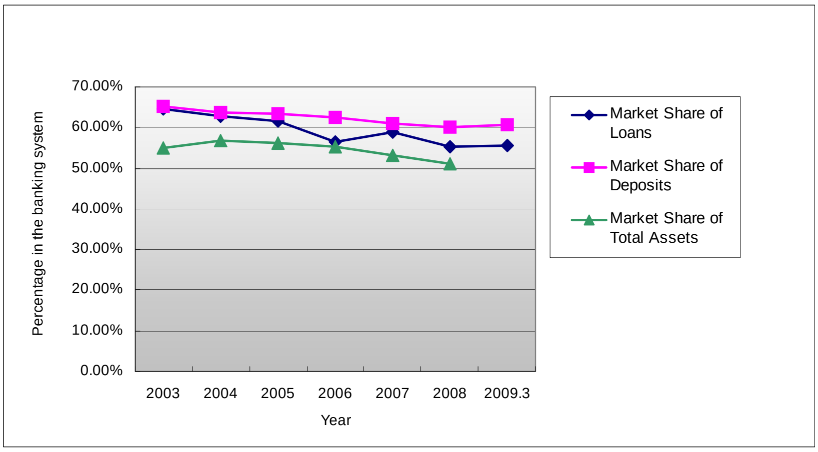
Nevertheless, simply arguing the influence of foreign banks on the whole banking system by citing their growth is not convincing enough. That is, when using a macro lens to see the position of foreign banks, their growth does not have significant power to shake the whole banking system. Their market share, in terms of deposits, loans and total assets, are all below 3.5% in the Chinese banking system. In contrast, the market share of the big four banks in terms of these three aspects, although it has been continually decreasing since 2003, still account for more than 50% in each of these aspects of the banking system. By this comparison, the big gap between the small foreign banks and big four banks has not changed significantly, and over 50% of financial resources are still highly concentrated within the big four banks, which is classified as a Type III Oligopoly in J. Bain's model. By the same token, when looking into the institution split of total loans and deposits, the portion that foreign banks attain is too little to compete with not only the big four banks but also other financial institutions (Figure 4-3 and 4-4). This shows the very marginal influence of foreign banks in the whole banking system.

Figure 4-1: Foreign banks – market share of deposits, loans and total assets



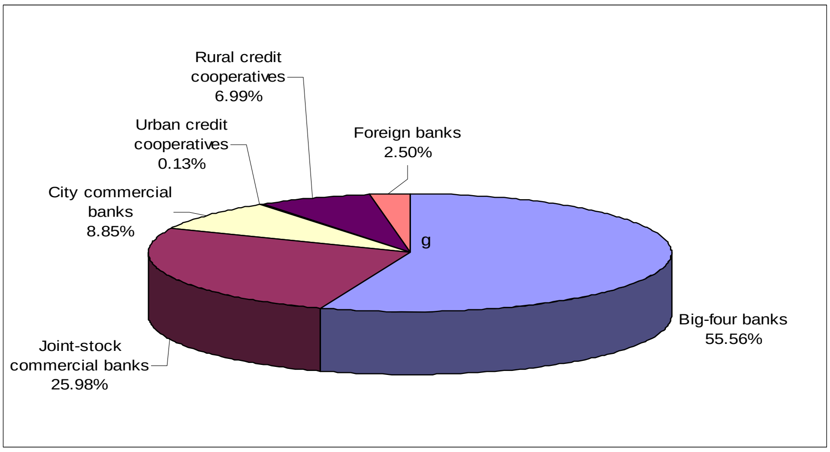
Source: CEInet Industry Database from 2003 to 2009 March, CBRC (2008)

Figure 4-2: The big four banks – market share of deposits, loans and total assets



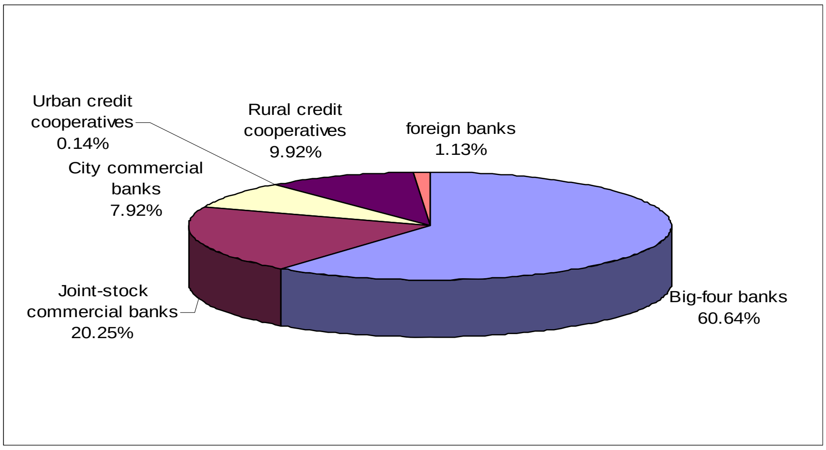
Source: CEInet Industry Database from 2003 to March 2009, CBRC (2008)

Figure 4-3: Institutional split of total loans in March 2009



Source: CEInet Industry Database in March 2009

Figure 4-4: Institutional split of total deposits in March 2009



Source: CEInet Industry Database in March 2009

Therefore, the limited growth and influence of foreign banks explains the limited effects of the WTO which otherwise intends to promote the idea of financial liberalization in the world. This situation also conflicts with the previous literature which claimed that competition led by foreign financial institutions would be severe after WTO accession and the big four banks would eventually lose their dominant position. Arguably, these claims and worries were an over-reaction because there is no big difference between the structure of market share in 2003 and the first season of 2009. This empirical research, therefore, presents a limited role of that the WTO plays in the Chinese banking system.

2. The insights of the Chinese financial policy

As discussed in Chapter II, financial liberalization was not the priority during the WTO negotiations. Even after WTO accession, evidence drawn from the disputes over the new regulations and the intact dominant position of the big four banks shows that the Chinese government is still not a supporter of the idea of financial liberalization. Arguably, financial reforms and financial liberalization are two different financial policies to the Chinese government. Being aware of the problems lying in an obsolete banking system which became the obstacles of economic growth, the Chinese government wanted to implement certain reforms to improve the system. However, these reforms did not include the vision of financial liberalization which might allow the Chinese financial system to be exposed to the dynamic of the international financial market and threaten the Chinese government's control over this system. When the commitment to opening up the banking system was an inevitable requirement to enter the WTO, the Chinese government, on the one hand, managed to use the WTO as an excuse to implement some reforms that had long been resisted by some interest groups. On the other hand, it withheld free market access from foreign banks by means of complex regulations and the undefined prudential principles.

Detailed explanations are discussed in the following contents.

Arguably, the relationship between China and the WTO is tender. That is, not only does China need to join the WTO to attain its economic and political interests, but the WTO also needs China, a country with one-fifth of world population and a big economy. In this regard, China is in a strong bargaining position and will likely deviate if its interests exceed the benefits gained from the compliance. Moreover, these interests refer to the interests of the Communist Party of China (CPC) instead of the whole nation. It can be argued that, relinquishing central government's control over the banking system does not meet the interests of the interest groups that are in power. With the fear of losing power, the higher officials have strong incentives to maintain their control over the allocation of financial resources. Cheng (2006) claims that this fear of losing power stems from the historical experiences, most notably the Tiananmen Square protests, which made the CPC realize that it could never gain the support from the public as a whole[17]. More reforms would only result in more requests from the public and spill over from the economic to the political aspect. Thus, the CPC would eventually lose its power by introducing economic reforms if it does not control the key economic resources in hand. Ho (2005) further claims that the economy in China has been transformed from monopoly to oligopoly, and this dominance is driven by political concerns. Hence, with this interest-driven political will combined with the concerns on the country's reputation, the behaviour of outward compliance is self-evident. In reality, the state remains an overwhelming shareholder in the big four banks and the dominant position of the big four banks in the whole banking system remains intact and unshakable.

[17] According to Cheng Xiao-Nong, the Chief Editor of the *Modern China Studies*, he quoted a policy paper made by a son of a Chinese higher official who suggested the government to adjust its 'economic reforms based on the consideration of social justice' to one based on 'oligarchy'. This paper was written after the Tiananmen Square protests (Cheng 2006).

Further, it is also worth noting how the WTO serves as an excuse for the Chinese government to implement some reforms which it has long wanted. The problems of the banking system, in terms of its structure, efficiency, asset quality and management, have always been trouble to the government. After decades of reforms, these problems were not solved in an effective way as discussed in the first part of Chapter III. The biggest hurdle came from the resistance of certain interest groups. Wu argues that:

> “Some groups, especially some elites, have interests in the old system. Some of the people from these groups can not place social welfare as their priority, and use a number of excuses (including political excuses) to obstruct the process of reforms” (Wu 2001:5).

Therefore, WTO accession provided the Chinese government a good chance to introduce some radical reforms to the banking system. Over the last seven years, the Chinese government successfully introduced several radical reforms to the big four banks, in the name of being prepared for the oncoming competition with foreign financial institutions after WTO accession. These reforms have transformed the structure of the big four banks and has also, to some extent, improved the asset quality and performance of these banks. However, these reforms do not significantly erode the control from the state. This can be seen from two facts existing in the current banking system. First, the market share of the big four banks is still over 50% and the state is the main shareholder in these banks. Second, recent news shows that the large commercial banks have boosted the amount of policy lending in order to support the expansionary fiscal policy made by the central government following the financial crisis in 2008 (*VOANews* 2009; *BBC* 2009). This situation signals that the Chinese government can easily interfere with the operation of the big four banks and prioritize policy lending before the commercial principles of other banks, such as risk management and profitability. Hence, as the Chinese government has effectively implemented several reforms on the four banks without losing its control, it is argued that

WTO accession is one of the strategies used by the Chinese government which is sophisticated to raise undue anxiety within the nation to achieve its goal and combat resistance to change.

Apart from the control over the big four banks, it is worth noting here that the Chinese government has further expanded its control over foreign banks. The 'Regulations on the Administration of Foreign-funded Banks of the People's Republic of China' creates incentives for foreign banks to be listed in China as a legal entity, instead of simply operating as a direct branch[18]. The intention of this policy is to subordinate foreign banks under the supervision of the CBRC, which makes the desire of government control over foreign banks self-evident.

Lastly, to elaborate more on the Chinese government's financial policy, it is argued that this slowly ongoing financial liberalization will be withheld or even reversed for a longer period of time. This is because the recent global financial crisis has helped the Chinese government to consolidate the legitimacy of its control over the financial system. When the discourses of nationalization and tightened regulations are prevailing all over the world, that most of the developed and more liberal financial systems in the western countries are badly affected by the crisis which is mainly created by insufficiently regulated financial innovations, and when the Chinese people read in the newspapers that the importance of the G8 is likely to be replaced by the G20, all of this makes the idea of a restricted financial system and policy all the more unchallengeable and even favorable in China. Moreover, the Chinese-style financial system becomes to be seen as a relatively stable system compared to other countries and further contributes to the increasing importance of China in the international arena. In this regard, the Chinese government seems to have incentives to maintain the

[18] Please refer to page 27-28.

current situation because it not only serves the interests of higher officials, but also gives China more bargaining power in international politics.

Chapter V – Conclusion

To conclude, three decades have passed and a series of reforms has been implemented to the banking system in China. These reforms correspond to the timeframe of WTO accession, which makes the WTO appear to be a seemingly important player in the Chinese banking system. Further, it also leads to a general proposition that the Chinese government has been gradually relaxing its control over the financial resources and supporting the concept of financial liberalization. Therefore, in order to understand the actual role of the WTO and the essence of the Chinese government's financial policy, this thesis investigated the changes to the banking system, focusing on the two most representative sectors – the big four banks and foreign banks.

When breaking down the timeframe into three stages, it is found that there was noticeable improvement that happened after WTO accession. However, the growth of foreign banks and the internal reconstruction of the big four banks has not shaken free the dominant control of the Chinese government on the whole banking system. In other words, the degree of financial liberalization remains low and the policy of state control of finance remains. This situation also shows the limited influence of the WTO on the Chinese banking system and, therefore, dispels the myth of WTO accession and financial liberalization. In addition, the whole reform process and its outcomes can be explained by a little political will from the higher officials in China and the sophisticated strategy used by the Chinese government to disguise its intentions by using the WTO as an excuse to combat resistance and improve the weak big four banks. Lastly, the final argument of this thesis is the unlikely improvement in the financial liberalization of the banking system in the near future, given that the global financial crisis in 2008 has consolidated the legitimacy of a policy of financial restriction in China.

This thesis, however, has some limitations. First, the availability of the data is the biggest limitation, which impedes the possibility of the author investigating the changes to the whole banking system within a limited timeframe. Secondly, by the same token, the author only chose two of the most representative sectors – the big four banks and foreign banks – and this inevitably creates a research bias in the interpretation made by the author. Therefore, further researches can explore other sectors in order to present an overall scene of the changes to the banking system in China. Lastly, the credibility of the data is questionable. The data collected from the four chosen databases are sometimes inconsistent, which may also lead to a research bias. However, this problem can hardly be solved unless there is significant improvement in transparency in China.

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