CHINA WTO AND THE FINANCIAL SECTOR

Preet Malik
Former Secretary, Ministry of External Affairs

China's financial system remains an area of weakness and a recent audit carried out by the National Audit Office made the point that "China's three largest state banks still lack proper risk control procedures." The audit also stated that the 'loan application procedures, particularly at the branch level, are not strict enough where they knew the applicant." This was a deliberately nuanced statement attempting to point out that the system still remained one where the local party chief made the recommendation and the loan was sanctioned without any attempt to carry out the due diligence responsibilities before the bank concerned committed itself to making the loan. The audit report which was posted on the official web site was immediately withdrawn.

Attempted below is an examination of Chian's financial system which today stands to an extent more open to global influences because of the compliance by Beijing with its WTO commitments.

INTRODUCTION:

China's financial sector is weak, carrying a massive burden of NPA's. According to all established experts and institutional studies the State Enterprises in China owe the state-owned commercial banks around US$ 850 billion, the latest figures place it at US$1 Trillion. (As one of the leading experts on the financial side has stated, although no one knows for sure, China's banks and instrumentalities are probably sitting on a trillion U.S dollars of doubtful loans. Interestingly, an Ernest and Young study which gave somewhat moderated but still a staggering figure of bad and unrealisable loans had to change its stand and amend its report to meet Beijing's objections and opposition. Proof positive of both the sensitivities of the regime to a critical assessment of its financial jugglery and the extent to which it is willing to take on any neutral reporting on the financial sector which does not agree with the image that it wants to project.) The latest acknowledged position by the China Banking

Regulatory Commission shows that the NPL's of the commercial banks at the end of 2007 were at over RMB 1.2 Tr amounting to 6.17% of the total loans made. This is considered by most experts to be a case of gross under reporting.

The present position, on account of the economic reforms that have so far taken place, is one where China faces considerable social and economic stress. To which the non-performing loans of the banking system, corruption, the lack of profitability and performance by the existing SOE's are adding a considerable, and to an extent an unmanageable, burden. The administration has shown a reluctance to add to the sources of stress that would follow in the footsteps of WTO-generated foreign competition or out of "uncontrolled capital investment from abroad."

It is been recognised by the reformers that financial reform is an essential condition for the future high-level growth of the economy. This is, however, the most difficult area in which market-determined change can in real terms take place. The accession to the WTO has made China open up its financial sector and to a reasonable extent it has arrived at acceptable compliance levels. However, there remain gaps particularly in fulfilment of the basic requirement of extending 'national treatment' to foreign financial entities that have entered and established themselves in China. The general understanding is that China has failed to ensure that the policies are non-discriminatory and in fulfilment of the WTO bindings that call for equality in application of national treatment.

Financial services carry the largest political burden for Beijing. For China "finance is among the most politically charged areas of the economy and one of the most difficult to make market-oriented," (Panitchpakadi & Clifford). The reality is that the Chinese authorities, both national and local, use the financial sector to control the direction of the economy and to motivate it to their way of thinking. It is still being mentioned by international experts, and this has to some extent also the backing of international institutions, that China's commercial banks are 'burdened by the world's largest misallocation of capital.' – the suggestion or claim being that the banks are considered as a "secondary budget" (Chang) to support ailing state enterprises and to effect uneconomic public investments. In effect, it is contended that the lower tier governments in China have a recorded debt that is estimated to be 10% of GDP with another equivalent of 10% as unrecorded debt.

COMMITMENTS UNDER GATS:

At the (WTO) Working Party deliberations in Geneva, the Chinese negotiators for all practical purposes have reiterated commitments that they had made at the bilaterals and the ensuing agreements that they had signed with the United States and the EU. This included commitments on issues of transparency, level playing field between national and foreign entities operating in China, market access and the assurance that China's licensing procedures and conditions "would not act as barriers to market access and would not be more trade restrictive than necessary."

The effective commitments by China under GATS are fairly far reaching in comparison to the prevailing Chinese practices in the financial services sector. The commitments cover the areas of commercial banking, the non-banking financial area, asset management, securities business and insurance. The position on commitments under the GATS is as follows:

- Commercial Banking: foreign banks can open branches and receive non-discriminatory national treatment after a transition period of 5 years. Two years after accession foreign banks could conduct local currency business with Chinese companies. After five years they will be able to set up accounts for ordinary Chinese retail clients. In the first two years after accession foreign banks can only do business with foreign clients; after two years, however, they can serve local clients.
- Non-bank financial activities: China has permitted foreign non-banks to provide consumer credit for the automobile sector. This will eventually also cover all consumer credit areas.
- Asset Management: Here China has been more restrictive in order to prevent foreign AMC's from controlling this sector in China. The restrictions are competition-derived and provide for the locally constituted AMC's to get sufficient breathing space. Accordingly, the foreign companies can do business in China as minority (33%) partners to Chinese asset managers. After three years subsequent to the accession the foreign holdings can go up to 49%. In other words controlling interest will be retained by the local AMC's.
- Securities: Again, this remains a restricted area. No entry is permissible till after three years from accession. Thereafter foreign players can be minority holders in on-shore

securities and brokerage firms. However, the JV's could underwrite corporate securities and government bonds.

- Insurance: China has agreed to maintain prudential standards for approving the licensing of insurance companies. There is a 50% ceiling on foreign equity in life insurance. Non-life assurance, however, permits 51% equity to the foreign partner for two years after accession. Thereafter the foreign parties' share of equity could go beyond 51% without any ceiling.

The prevailing socio-economic and ideological conditions have continued to impact on the extent of the opening up of the financial services sector in compliance with the WTO commitments. The nature of China's political structure, which emphasises socialism, remains a major influence when it comes to implementation. First, let us take a look at the prevailing conditions and the role of the government so far as policy determination and regulations. It has to be noted that WTO entry, as expected, has had a degree of intrusive impact on the financial sector as China's relatively under developed banking and brokering sectors have come to face WTO-induced competition. Change is already on the way; for instance, it is estimated that almost a third of China's burgeoning foreign currency reserves are in the nature of speculative flows linked to participation in the capital markets.

CHINA'S FINANCIAL SECTOR STRUCTURE AND FUNCTIONING:

It can be said that China has a financial sector that looks good on paper and it has incrementally expanded and is showing signs of some sophistication as a result of the economic reforms. Its four commercial banks, all of whom state-owned, are among the largest in the world when their assets are taken into account. They are the main beneficiaries of the very high Chinese rate of domestic savings. According to the World Bank and other experts, the rate of savings is placed at 41%. At the same time the loans amount to US$1 trillion.

China's market capitalisation, taking its two largest stock exchanges of Shanghai and Shenzhen into account, has been placed at US$ 602 billion. This is larger than the Hong Kong stock market.

These facts tend to suggest that China has a reasonably well developed and established financial sector offering a good set of financial instruments and a stable fixed deposit system for the savings-conscious Chinese. This is, however, only what is apparent at first glance. A slightly deeper look at the system and the structure and a somewhat different position emerges. A summing up by experts that include eminent academics like Nicholas Lardy is that China's is a "primitive, politicised financial system, whose players will have trouble competing with world-class financial institutions."

China's commercial banks have traditionally functioned as the collectors of deposits from individuals and lenders to state owned enterprises. Lending is dominated by the four commercial banks:

- The Industrial and Commercial Bank of China.
- The Bank of China.
- The China Construction Bank.
- The Agricultural Bank of China

They account for 66% of all loans in China. As already mentioned, China's SOE's have been very poor performers in the utilisation of the loans extended to them by the commercial banks and a very high proportion of the loans is neither being serviced nor being repaid. A brief case history (2002) serves as an example of the manner in which the financial system has so far been working; a reading of it certainly makes the situation very clear.

The China Construction Bank was made to extend a loan for the construction of a railroad of 100 kilometres from a coalmine to a proposed power plant. While the power plant was not constructed, the railroad was completed. Without the power plant to service, the railroad has no commercial or economic substance that would make it a viable proposition. The result was predictable. The loan has not been serviced and the state enterprise has made no move to meet its loan commitments. The question of the loan being repaid does not arise. It is not being repaid and is an effective NPA. What is more telling is that the liquidity to effect the loan was created out of the public deposits taken on by the bank in the normal course of its business. The loan having turned bad, it should have been classified as non-performing and the assets created by the loan should have been possessed

and, to the extent feasible, the assets sold and at least some of the loan out standings recovered. Instead, the loan has been set off against the asset that is being maintained and is shown as a performing asset at the disposal of the Bank. As such, the Bank has in the past paid tax on the business it conducted by extending the loan. It has not been permitted to write off the loan and show the loss made on it to enable it to claim a tax write-off.

As is clear from the above case history, such loans should be treated as subsidies to industry paid out by the banks without the benefit of these being treated as funds backed up by government guarantees and as such not a charge on the banks' assets or borrowings in the form of public deposits. When China's transition period is over it will have to, under normal circumstances, restructure the economy in such a way that subsidies are within WTO acceptable norms.

In structural terms, China has reinforced the barriers between financial services. The 1995 Commercial Banking Law prohibits commercial banks from entering into or participating in non-banking financial activities. Under this regulatory action banking, securities, brokerage and underwriting, asset management and insurance are all separate activities. One of the chief motivations of this approach under the Chinese law was to place strong impediments in the way of speculation. However as Amy Chunyun Wu has put it, the bulk of the speculative resources (hot money) has "actually passed through the SOE's, which are the principal borrowers of the Banks." An examination of China's new banking laws shows that they have failed to address this issue. According to Wu "over speculation is an industry-wide phenomenon. In fact the system actually encourages SOE's to speculate." This is how this works:

- The SOE's are, despite the adoption of the Company Law and the bankruptcy laws, for all practical purposes bankruptcy-remote, in fact almost bankruptcy-proof. This happens because of the manner in which the state has tended to permit debt-ridden state enterprises to avoid bankruptcy and continue to carry on business on the basis of operational profitability without including the cost of financing or providing for the servicing and repayment of the debt.
- The SOE's are permitted to keep the gains that they make. They are not compelled/ expected to make a provision for meeting their debt on loans received by them

from financial institutions. As in the past, loans, for all practical purposes, have been treated as plan funds received out of the administration's financial budgets.

- In cases where a loss is sustained on account of speculation it is shared with the state. Again, there is nothing to impede the enterprise management from continuing its speculative activities that are motivated primarily by the need to meet the operational profit targets of the enterprise.

The factor of speculation, however, forms a limited albeit important portion of what is wrong with the financial sector and the problem that it implies for the economy as a whole. To better understand the problems that afflict the banking sector and the concurrent problem of subsidisation of the state sector it is important to analyse the factors that are responsible for the continuing problems faced by the financial sector.

First of all, it is necessary to identify the main causes that have contributed to the state-owned enterprises' debt. This provides an insight into the problems that the commercial and cooperative banking sector in China is confronted with. It also underlines the areas that the government will have to address if it is to meet its obligations under GATS and be in compliance with its accession undertakings. The problem areas can be summarised as follows:

1. Poor economic efficiency which is disadvantageous to the debt-equity ratio. While the enterprises reporting profits had a debt-equity ratio of 65 %; those making losses had a ratio as high as 99.65%.

2. The reform policy contributed to the problem. With the change in policy from the state extending loans in place of the earlier policy of providing funds, many of the newly established SOE's went the route of borrowing heavily and were not able to meet their obligations out of their turnovers.

3. Unsatisfactory capital funding structure. The depreciation charges levied on the state enterprises by the state, which have to be paid out of the capital funds of the enterprise, have resulted in a large-scale draw-down of funds by the state from the SOE's. This has resulted in the enterprises not having the means to enter into fresh capital spending in order to meet the upgradation requirements of the industry. To meet their capital expenditure requirements the SOE's have had to borrow from the banking system.

4. Poor profit retention and a heavy social burden. The SOE's have for a long period of time had very low profit retention, while having to meet the heavy burden of obligations for social security, medical facilities, education and housing. With a very low level capacity to accumulate funds, the SOE's have had to resort to heavy borrowings to meet their state-imposed obligations.

5. Excessive enterprise investment and duplication of projects. Despite the reforms placing the decision-making responsibility on the management of the enterprises, the fact is that they were only held responsible for their profits and not for their losses. This has led to a strong desire on the part of the management to increase investment based on borrowings and the creation of large-scale debt. The management has had a tendency to borrow blindly for investment without carrying out the essential due diligence or calculating the cost of borrowing, the efficiency of the investment and the ability to effect repayment. This close relationship between the banks and the state enterprises led to increased investments, project duplications and losses all around.

6. Banks were extending loans without conducting a detailed examination of the loan request, by tallying it with the ability of the project to make profits or for that matter to service the debt. The loans were the outcome of political fiat and not based on commercial banking principles. This is why the combination of investments based on unthinking enterprise determination and loans on the basis of political considerations led to heavy debt burdens that the enterprises could never relieve out of their own profits or resources and such loans turned quickly into real term NPA's.

The reason for the poor performance of the state owned enterprises, which in turn has had such a major negative impact on the financial economy of the state need to be summed up in order to show why the systemic changes have yet to really work. The following, in brief, are the key factors that are responsible for the poor performance :

- The SOE's continue to rely excessively on the government rather than grabbing the opportunities granted by the management responsibility system.
- Enterprises also carry the burden of past practices whose impact continues to impose a material and financial burden on them. SOE's continue to bear the industrial distribution costs that are a hangover from the planned economy. And because of the skewed financial structure and tax responsibility system the

enterprises lack capital and reserves as well as operational funds. This has led to a very high capital liability rate.

- The ownership system places property rights of the enterprises into question raising doubts about the entity that would be responsible for assuming the full responsibility for the losses and profits of the enterprise. Enterprises do not have asset management power. This comes in the way of the SOE's adapting to market fluctuations and changing their product structure to meet the realities of market demand forces. Enterprises are unable to make products that are suitable for the market, as this requires the capacity to change the product mix by changing the asset structure to meet market needs.

- Slow to respond to changing market conditions. Production policy yet to be fully coordinated to relate to market factors.

- Bureaucratic interference that reduces the capacity and ability of the management to determine and relate production targets to market demand and to reduce stockpiles in keeping with operational requirements. This comes in the way of the management reducing costs and bringing in the necessary production flexibilities to take full advantage of market conditions/factors.

- Limitations on the market mechanism determining operational strategies and costs as the SOE's are made to function more like welfare societies rather than business entities. Enterprises are saddled with an impossible social welfare system.

- Refusal to bind management and workers to the principle of wages and bonuses being performance-linked.

The position has in one sense worsened with some of the changes in banking policy where the prudential norms are now to an extent being invoked and loans by the commercial banks are now in principle being made on commercial norms. This has made it difficult for the SOE's to borrow from the banks and has resulted in greater liquidity with the four commercial banks in the past two years. This is particularly so because these banks are finding it difficult to make loans to the non-state sector. Their preference is still to make loans to those SOE's that are even marginally able to meet the norms of commercial loans. The other thing that the banks have moved into is credit consumption. Live now and pay later has assumed a significant market and banking importance. The selected areas are

housing, automobiles and the knowledge industry. There is thus a proliferation of credit cards; departmental stores discount cards and instalment plans. All this is again providing a mixed result.

THE BANKING POLICY:

The factor to take note of is the role played by the government as the owner of the banking institutions in China, to force the lending power of the banks to extend low cost financing to the SOE's. In actual fact, the approach of the PRC Government to the reform of the financial system has at best been inconsistent. While the People's Bank of China, which is the Central Bank, has the responsibility for laying down the banking principles, the Finance Ministry sets the accounting rules and the taxation policies. This has led to discrepancies in management and policies affecting the entire official banking system.

The Central Bank makes pronouncements on capital adequacy ratios to be maintained by the banks and also calls on them to impose prudential management norms by classifying and making provisions for NPA's. However, it does not have the power to enforce these core requirements. It is the government through its Finance Ministry that lays down the practices to be followed by the banks primarily motivated by the demands of maximising the fiscal income. This is underlined by the tax on the banking sector that amounts to an 8% business tax on gross income and a limitation on tax deductible write-offs on account of NPA's to less than 1% of total loans. Net income is taxed at the statutory rate of 33%. The banks are not able to make a practical deduction on account of loan loss expenses and are forced to make unrealistic tax payments, which ensure that they end up dipping into their public deposits to meet their tax liabilities.

In 1994 the Government decided to differentiate between the commercial and the developmental operations of the banking system. The decision was taken to separate the purely policy banks that would serve the developmental needs from the commercial banks. This led to the forming of three Development Banks. By this move it was made out that the four Commercial Banks would extend loans on a purely commercial basis. The reality is that nothing of the sort has happened. In fact, if anything, during the real estate boom period of the 90's the situation of bad loans, illegal loans and NPA's had worsened. Further corruption in the form of loans to public officials for overtly speculative purposes has added

to the losses on account of illegal activities. According to the National Audit Office, the Industrial and Commercial Bank of China and the China Construction Bank had each lost $1.2 billion on account of such illegal activities!

There is little available data on the actual size of the non-performing loans in China. Whatever official information is available makes it impossible to judge the actual size of the non-performing loans, or distinguish between the loans that would be written off completely and those that may be facing temporary difficulties and could ultimately be recovered either wholly or in large proportion. According to the Central Bank Governor Dai Xianglong (in 2002) approximately 25% of the loans are NPA's or potential NPA's. Independent experts including from the IBRD place the NPA's in the region of 40% to 75%. In 2001 the Governor of the Central Bank released figures that officially for the first time admitted that 28.8% of the loans were NPA's. While this is still lower than the estimates of independent experts it does indicate that the banking system is in considerable disarray. Even at the figure now accepted by the Central Bank the NPA's are close to US$ 300 billion. According to figures that are accepted by the World Bank this is closer to US $ 500 billion.

Whatever the exact level of the NPA's, every expert without exception has pointed out that the NPA's have to be dealt with expeditiously and with determination in order to place China's banks on a sounder financial footing to meet the situation that market opening is creating.

The government is now moving towards the listing of the shares of the state- owned banks on the equity markets. This would mean that the banks should have to adopt greater and publicly more acceptable accounting and responsibility norms. At the same time with the commitments to the WTO, China will face the entry in greater force by the foreign banks and a greater role in the domestic economy by the non-state banks. The non-state banks are already competing for business in the market for loan customers and for public deposits and for foreign currency business. An aspect of the situation relating to public deposits has been that hitherto the savings were almost entirely moving into the public commercial banks and cooperatives and the government would decide to reduce the interest rates whenever it felt like. Now with alternative sources attracting savings as public deposits and the market set to determine the interest rate regime there will be greater competition in the market to the benefit of the consumer. This in turn will place a greater burden on the public banks to function on a competitive basis and to meet commercial standards.

THE OPERATIONAL FACTORS OF BANKING:

According to a survey conducted in 1999-2000 foreign banks had opened 155 branches in China with total assets of US$ 31 billion. 47% of these assets were in Shanghai; 22% in the greater Guangdong area; and 14% in Shenzhen. The rest was divided among the major cities. Asia-based banks extended approximately 62% of the loans. Prior to the WTO accession China had entered into a phase of partial liberalisation on the entry of foreign banks with approximately 32 foreign banks being permitted to carry out local currency transactions in Shanghai and Shenzhen. At the end of 2000 foreign banks held local currency loans, which amounted to a 2% share of the domestic market, and foreign currency loans that formed 20% of the domestic market share. However the held deposits were considerably short of their loan portfolios. This resulted in their having to make up the difference by inter bank borrowings that meant a higher cost and led to their incurring term mismatch risks.

A more important factor is the overall cost competitive situation. For the big four Chinese commercial banks the cost of equity is placed at zero. The Ministry of Finance regulates cost of deposits. The big four banks are covered by the protective safety net which is extended to them by the state. Accordingly the average cost of capital for them is very low. The non-state banks are not protected in a similar vein, and as such, have to build their own capital to cover the risk element. Obviously the system ensures that there is a distinct lack of a level playing field. This also ensures that when the full liberalisation of the banking sector does take place in compliance with the GATS obligations the non-state sector will have to offer higher returns to attract public deposits and thus add to their costs.

ASSET MANAGEMENT COMPANIES TO MANAGE THE DEBT PROBLEM:

In 1999 China sought to clean up the debt problem by permitting the establishment of AMC's. The action taken was to set up a dedicated AMC for each of the four commercial banks to take over its non-performing loans. Nominally independent, the AMC's are staffed by personnel who originally worked with the commercial bank concerned. The actual handling of the bad debt problems has been unsatisfactory with the state's concern being to reduce headline loss rather than looking at the long term cost of sub-par assets that are a drain on both the banks and ultimately the tax payer. According to Nicholas Lardy China

faces a financial crisis with bad loans continuing to mount, the AMC's are not doing their job and there are few signs of reforming the traditional credit culture. Lardy who is a recognised expert on the Chinese financial system places the bad debts at 75% of China's GDP.

The issue of bad loans and their resolution is a matter critical to the future of the Chinese financial system with the conclusion that the longer the system continues in the phase of low accountability the higher is the ultimate bill that the country, which means the tax payers, will have to shoulder. The other question that is of importance is whether the Chinese banks will be in a position to adopt accountable and modern credit practices. This would require that the politically directed and oriented lending has to come to a stop and the banks have to follow strictly commercial principles in making loans. What seems to be a move that will bring greater responsibility to the banking system is the decision to list the state-owned banks on foreign stock exchanges. Such listings would provide capital and more importantly bring into play oversight by institutional investors forcing in the process that these banks be held accountable for making bad loans.

CONCLUSION: A MODERN FINANCIAL SYSTEM AS OUTCOME OF WTO MEMBERSHIP AND COMPLIANCE WITH GATS COMMITMENTS:

The commitments made by China under GATS on the financial system have been listed above. What has to be monitored is the extent of the compliance that China will in reality bring into play. What is clear is that the accession to the WTO will create opportunities for foreign and domestic players to enter China's "booming" market for retail financial services. However, for the time being the hurdles will remain. What is likely to favour the more competitive services offered by the non-state banks in preference to the state banks is the growing change in consumer preference.

At stake is an enormous untapped market for financial services in a country that has a rising middle-income urban population. Today, for instance, there are an estimated 30 million urban households with an earning of more than $ 4300 per annum. This category is reported by experts to be doubling every two to three years. Rough estimates place approximately 4 % of these households holding deposits of $ 100 000 or more.

Surveys by foreign bodies like Gallup and Mckinseys are suggestive of a change in attitude of the Chinese consumers, who, according to these surveys are becoming "enthusiastic borrowers." For instance only 39% said they preferred deposits to securities as against the Asian average of 63%. In fact 38% of the upper and middle income Chinese actually hold securities; this is the highest average in Asia. This makes the banks that partner with securities brokers, insurers and other providers of financial investment products stand to gain from this above average risk-taking impulse that is guiding the Chinese investor. Currently and even in the future the system seems to be tied to the JV route with the foreign entity not necessarily having the right to majority holding even after the transitional period permitted under the GATS obligations and bindings by China. Currently they have entered this route through the 33% equity route that may ultimately go upto a possible 50:50 per cent equity relationship in the best case scenario, with a distinct possibility that the foreign equity may not be permitted to exceed 49% with the controlling interest remaining with the local partner. This is likely to remain a major impediment and is most likely to become a matter of further difficult negotiations with the Chinese at the WTO.

The present Chinese disposition seems to be to move in the financial sector slowly in order to provide ample opportunities for the domestic players, both state and non-state, to develop Chinese products that will be able to withstand the foreign onslaught. The claims by the foreign entities, which are bound to have the necessary political backing from their host governments, will in all probability follow the line that free entry of foreign entities would lead to a rapid upgradation of China's securities markets and would benefit the Chinese investors. The question that only the end of the transition period will resolve is the extent to which China will permit a level playing field and free competition involving an evenhanded, transparent and accountable financial system.

What the Chinese system is already faced with is that over 20% of the best customers of the big four Chinese banks have switched their primary banking relationship since 1999. Government regulations have tended to make the product offerings and interest rates extended by the big four identical, which has led to deep dissatisfaction with what is on offer and the lower service standards in comparison to what is on offer elsewhere. In fact many of the affluent Chinese clients have moved over to the new consumer-oriented competing banks.

It is obvious that the Chinese banks in order to be ready to face foreign competition as well as competition from the private sector will have to take several steps such as:

- Upgrade their customer databases and management information systems to have hands-on knowledge of the performance of each branch and of each product line.
- Identify their best customers and track the profitability of various customer segments.
- Segment their customer base to offer more distinctive, higher quality products and services to the most attractive segments.

This paper has addressed the present position and the impact on it of the traditional financial system that in the next three to seven years will be gradually opened up to the full force of global competition. To what extent the state in China will be able to move away from an over centralised and controlled regime to one that would permit freedom to the competitive forces to modernise the financial system will have to be monitored. In the meanwhile it has to be accepted that China has the capacity to surprise those who feel that its current liability-ridden state economy will continue to impose a negative force on markets, hampering its further rise in the global league.

THE CURRENT POSITION:

In conclusion, it would be appropriate to state that the WTO Trade Policy Review of 2008 (TRP) observes that "China's capital market remains heavily dependant on the banking system, which is still under-developed and relatively inefficient." This is polite multi-lateral institutional language which in real terms means that, despite the opening up to global influences and the regulatory reforms that have been put in place, the domestic system that remains paramount is one that tends to breed inefficiencies. While it is an imperative of the market economy that it requires institutional curbs on government, these would also be a limitation on the power of the party.

Again, the TRP refers to 'lack of access to external financing through the capital market for domestic private enterprises relying heavily on retained earnings.' Other experts have continued to make the point that a lot of the funding and investment of industry is through alternative funding sources outside the banking system. It should be stated here that while the domestic banking system in China has done enough 'not to slow down the economy' the alternative financing channels have had great success in supporting the Hybrid Sector which contributes 'most of the economic growth' compared to the State and the Listed Sectors.

In order to meet the WTO commitments on permitting foreign financial institutions to enter and operate in China (which in the first instance were not permitted to offer business in local currency), in 2006 the new regulation was adopted to permit foreign funded banks to offer RMB business to Chinese nationals, with no geographical restrictions. However 'stringent qualification requirements still apply to FFB's' that continue to restrict their functioning and limit their business reach. To sum up, restrictions continue to prevail and these continue to favour the domestic banking industry.

What is a compelling factor in the WTO compliance requirements is that China now has to extend to foreign banks the full force of "national treatment". This would entitle the foreign banks to take local currency deposits and to engage in all 'types of corporate transactions.' This could have a major impact on the asset-related problems of the state-owned banks as they are dependant on creating liquidity through deposits that are linked to the extremely high savings rate of 40 %.

What has to be pointed out is that the debt ratio to GDP in China is very high and is certainly well above the officially admitted figure in a situation where the banks seem to function more as an extension of the state budget support mechanisms rather than banking institutions that follow regulatory and banking norms. Arguably, the nature of the Chinese system is such that it would not like to have a situation where the FFB's could compete and take away 'new cash'. This would imply that compliance with WTO and modern banking norms would be restrained and controlled.

* * *