

WTO ACCESSION AND FINANCIAL REFORM IN CHINA

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After years of endless efforts, China has achieved agreements with almost all the World Trade Organization (WTO) members, which requested to have bilateral negotiations with China. The U.S. Congress also voted to grant China Permanent Normal Trade Relation (PNTR) status, removing another hurdle of China's accession to WTO. It is most likely that China will be admitted to the WTO this year.

Possible Impacts of WTO Accession

Top Chinese leaders regard the WTO accession as the second most important change in China's economic policy regime, following Deng Xiaoping's reform and opening-door policy in the late 1970s. This change will have undoubtedly profound impacts on the future course of China's economic development. There are many discussions among academic and policy circles in China regarding the possible impacts of WTO accession on the Chinese economy. Some scholars and policymakers are very positive about the accession. They believe that any drawback will be overwhelmed by the efficiency gains, injecting new growth impetus into China's reform and economic development. According to them, China will enter an entirely new development stage. However, other critics are worried that China's weak economic base, due to the unfinished transition from a planned to a market economy, will not be able to sustain the tremendous external shocks brought about by entry to the WTO. They argue that the WTO accession will do more harm than good to the Chinese economy.

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My personal judgement is that, before the expiration of the grace periods in the bilateral agreements, most sectors in the Chinese economy will still be protected. However, in anticipation of the opening of China's domestic markets to foreign firms after the expiration of the grace period, foreign direct investments from multinational companies will increase substantially immediately after the accession. Therefore, the accession should bring an immediate boost to investments and a spurt to economic growth. In the long run, WTO membership will undoubtedly enable the Chinese economy to become more integrated with the world economy, facilitating a better access to foreign technology, capital, and the global market. Therefore, the accession will be beneficial to China's overall economic growth in the long run. The real challenge to the Chinese economy will be in the intermediate run after the expiration of the grace period but before the completion of adjustments to the long-run equilibrium. The intermediate-run challenges will certainly be different from one sector to another, depending on the gains and adjustments that each sector needs to make.

Financial Liberalization

One of the most sensitive issues in the bilateral negotiations is the problem of liberalizing the financial sector. In a market economy, the primary role of banks and financial institutions is to serve as an intermediary between savers and investors and to facilitate payments between economic units. Prior to the economic reform, China had a planned economy with heavy industry as its main target of development. The financial system was an integral part of the planned economy. Regular financial market activities were banned. The People's Bank of China (PBOC) was the only financial institution, serving as the central bank and at the same time providing commercial banking services (Lin, Cai, and Li 1996). After the start of economic reform, those previously banned banks and nonbank financial institutions were gradually reopened. However, the four big state banks, namely China Industry and Commerce Bank, China Agricultural Bank, Bank of China, and China Construction Bank, still dominate China's financial sector.

Statistical data show that by early 2000 foreign banks and financial institutions had already set up 191 representative offices and subsidiaries in China with total assets of \$36 billion in 23 locations, including Shanghai, Beijing, Tianjin, Shenzhen, and Hainan. Many foreign banks recently have been allowed to upgrade their representative offices to branches and to conduct local currency business in Pudong

and Shenzhen. For insurance, the Chinese government recently approved four foreign insurance companies to set up new branches or joint ventures.

After the WTO accession, China has agreed to remove the geographic and business restrictions within five years, allowing foreign banks to set up branches in all other cities in China, conduct local currency business, and provide retailing services. Foreign insurance companies will also be allowed to own up to 50 percent of the equity of the joint ventures and to operate in more cities.

It is predictable that China's financial sector will become increasingly open to foreign financial institutions after the WTO accession. For a long period, China treated the financial sector as a special industry, was very cautious in liberalizing the sector to foreign competition, and imposed many restrictions on the entry and operation of local financial institutions. After the WTO accession, foreign financial institutions will receive national treatment—that is, be treated the same as domestic firms. The state-owned banks and insurance companies will lose their existing protections. Therefore, competition in China's financial market is expected to be very strong.

The financial sector and state-owned enterprises (SOEs) must be reformed if China is to make the transition from a planned economy to a market economy. The high ratio of nonperforming loans in China's banking sector has received much attention.¹ The state banks have been burdened by policy lending. Meanwhile, the monopolistic nature of the state banks has resulted in low efficiency. Consequently, the overall quality of China's banking industry is poor and uncompetitive. In fact, China did not have a clear direction of financial reform until 1994. Since then, the four state banks have attempted to move their operations toward commercial banking. China has also set up a number of other regional and nationwide banks. In addition, the government has issued more licenses to domestic insurance companies and has a better understanding of the possible role of equity markets for the SOE reforms and for China's economic development.

After the WTO accession, the four big state banks' monopolistic position will cease to exist. Their asset values and volume of business are no larger than those of other major foreign banks, and their operations and techniques are not as advanced as those of overseas banks. Therefore, foreign banks have the ability to bring a large

¹Lardy (1998) estimated that about 50 percent of the outstanding loans of the four big state banks were nonperforming loans. However, the most accepted figure among the Chinese banking officials is 25 percent, which is still higher than the levels of nonperforming loans in Thailand, Korea, and Indonesia before the financial crisis in 1997.

enough shock wave to end the monopolistic nature of China's banking industry. Of course, the local banks, especially the four state banks, have developed a relatively complete nationwide service network. Therefore, they still have an advantageous position in this regard. How long that advantage can be maintained depends on whether local banks can learn from foreign banks, improve their services, and become competitive. That advantage, however, has its limitation. China's banking business is concentrated in the developed, coastal regions and major cities. Foreign banks can easily open branches in those areas. They will first compete for the high profits, low costs, and less risky business, such as international clearance. Data show that foreign banks have already handled over 40 percent of China's trade settlements.

Foreign banks and other international financial institutions appear to be very attractive to domestic customers because of the high quality and efficiency of services, the wide range of financial products and innovations, and the soundness of financial operations. Therefore, it is inevitable that certain business will shift from domestic banks to foreign banks. Foreign enterprises in China are even more prone to do so because of their familiarity with foreign banks' operations. In the loan business, foreign banks depend mainly on customers' credit ratings. Because of the transparency and efficiency of their business operations, profitable SOEs and private enterprises, as well as foreign enterprises, are inclined to borrow from foreign banks. Foreign financial institutions also have advantages in other business, including discount of promissory notes, insurance, and security investments.

The other competitive pressure facing China's financial sector after accession to the WTO will be in the saving deposits business. State banks' financial resources come mainly from domestic households and enterprises' deposits. One frequently raised concern in the domestic discussion of the WTO accession is whether or not the deposits will be shifted to foreign banks. Some officials fear this possibility would occur because of the concentration of deposits held by a small percentage of wealthy depositors. It is argued that they are likely to move their deposits to foreign banks because those banks provide better services and have sounder financial positions. If the relocation does occur, the state banks' problem of a high ratio of nonperforming loans will be exposed. That exposure could lead to bank runs and other crises if handled inappropriately, and could accelerate the relocation of deposits and further weaken state-owned banks. The survival of many SOEs depends on obtaining continuous loans from the state banks. If such a scenario occurs, the four state banks will not have the means to support the SOEs, and many SOEs would go

bankrupt. In my judgment, such a doomsday prediction will not occur because of the recent change from a system of anonymous banking to real-name banking. Any shift of deposits from state-owned banks to foreign banks will reveal those wealthy depositors' identities and place them in an undesirable position. Therefore, the competition between state banks and foreign banks for deposits is likely to be on the basis of competition for new savings rather than for savings already in the state banks.

It is clear that WTO accession will bring competitive pressure to the financial sector in China. Foreign institutions can bring in advanced management skills and business practices. If China's financial institutions can reform and master advanced business practices, develop new financial products, improve service quality, and cut down operating costs, they should be able to compete with their foreign counterparts. 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.

As China opens its financial sector after the WTO accession, foreign financial institutions will enter China's financial market, and domestic financial institutions will have new opportunities to develop. The latter possibility is especially important for China's long-term development. After the WTO accession, the Chinese government will not have enough means to support the nonviable big SOEs. The Chinese economy will have to develop more closely in line with China's comparative advantages, at this stage of economic development, namely, more in line with labor-intensive industries (Lin, Cai, and Li 1996). Most enterprises in the labor-intensive industries are small- and medium-size. The best way to meet their financial needs is to rely on local, small- and medium-size banks (Lin 2000). In the past, the government suppressed the development of local, small- and medium-size banks to favor the development of the four big state banks. The financial needs of the small- and medium-size enterprises were underserved. The WTO accession will provide a better opportunity for the small- and medium-size banks to develop, which in turn will facilitate the growth of small- and medium-size enterprises and enhance the Chinese economy's competitiveness.

Conclusion

China's accession to the WTO and subsequent entry of foreign financial institutions will exert a strong competitive pressure on China's inefficient financial sectors. The Chinese government will abandon inappropriate administrative interventions that have been imple-

mented for a long time and adopt policies that conform to the normal practices of a market economy. Financial regulations will be strengthened and become transparent. Interest rates will be liberalized and determined by markets. The treasury bond market and the central bank's open-market operations will become normal. The restructuring is likely to result in a rapid development of efficient financial institutions and the defeat of inefficient ones. 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.

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