

**INTERACTIVE ROLE OF GATS COMMITMENT AND DYNAMICS OF CHINESE
ECONOMIC REFORM IN THE CONTEXT OF BANKING LIBERALIZATION**

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ABBREVIATION

AMCs: asset management companies

BOPs: balance of payments

FOEs: foreign-owned-enterprises

GATS: General Agreement on Trade in Services

IFC: International Financial Corporation

IMF: International Monetary Fund

MFN: Most-favored-nation

NPLs: Non-Performing Loans

NT: national treatment

RMB: Renminbi (Chinese currency)

SCBs: state commercial banks

SOEs: state-owned-enterprises

The Big Four: Industrial and Commercial Bank of China, the Bank of China, the Construction Bank of China and the Agriculture Bank of China

UNCTAD: United Nation Conference of Trade and Development

WB: the World Bank

WTO: World Trade Organization

INTERACTIVE ROLE OF GATS COMMITMENT AND DYNAMICS OF CHINESE ECONOMIC REFORM IN THE CONTEXT OF BANKING LIBERALIZATION

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I. INTRODUCTION

China's GATS commitments represent the most radical services liberalization in the WTO negotiation history. China, one of the most closed services markets, has promised to become one of the most open in the world over a period of some five years. The pervasive view, both domestic and international, is that China was obliged to commit itself in financial service liberalization in exchange of WTO admission ticket. The issue of the GATS in the context of banking liberalization attracts much of the attention as China's banking system has been overshadowed by large amount of Non-Performing Loans (NPLs).

The central question is: Are the Chinese WTO commitments an act of imprudence, that may be perceived as a dramatic loss of discretion in policy-making and a move leading to economic instability, or, on the contrary, are those commitments economically, legally and politically desirable? If this is desirable, what are the underlying driving economic motives which had not been revealed officially or examined academically before? In addition, what are the necessary supporting and accompanying domestic reforms in order to maximize the benefits from the envisaged liberalization?

By applying both economic and legal analysis, this study attempts to identify the bottlenecks of domestic reform at the time China took the commitment shortly after the Asian financial crisis. Market failure, monopoly, inequality treatment, are three major barriers to further economic development. Essentially, there were compelling needs to create an enabling legal framework and a competitive environment for the emerging private sector. It is crucial to facilitate the transformation of the State-owned-enterprises and State-owned-banks and enable the reforms to be sustainable. In this context, the study will highlight what obligation GATS meant and how Chinese legislation responded. It further examines the interactive role of WTO commitment with Chinese domestic economic environment and development after China's WTO accession.

This paper is organized as follows. After a brief introduction in **Section I**, **Section II** presents a general picture of China's service commitment and banking sector commitment in particular. **Section III** analyzes the logic for China to conduct banking reforms endogenously and provides the rationale for the puzzle why China needs WTO to deal with the development barriers. **Section IV**, from a legal perspective, evaluates whether Chinese banking commitment would compromise China pursuing macroeconomic stability, and how effective regulations would help China to achieve the stability after WTO accession. In the **final** section, a conclusion will be drawn on the significance of China's approach that could serve as useful reference for other WTO acceding countries to make their liberalization commitments.

II. CHINA'S RADICAL SERVICE COMMITMENTS AND DEBATABLE BANKING LIBERALIZATION

China's services market has historically been heavily regulated, and foreign service providers' access to the market has been significantly restricted. China's WTO commitments, which became effective on December 11, 2001, represent the most radical services reform program ever in the WTO history as well as Chinese liberalization history. These numerous commitments cover general services sectors and 88 subsectors, subject to certain limitations.¹ Over a short period of five years, one of the most closed services markets has promised to become one of the most open markets.²

2.1. Overview of China WTO Service Liberalization Commitments

China has made substantial commitments in service sectors in cross-border trade (Mode 1), consumption abroad (Mode 2); and establishment trade (Mode 3), the extent of which is greater than the industrialized countries, other developing countries, or the group of recent countries acceding to the WTO.³ These commitments include financial sector, distribution, telecommunications, professional services, etc, through the elimination of many existing limitations on market access, at all levels of government.⁴ Those sectors are traditionally regarded as high margin field dominated by state-owned-enterprises (SOEs). Among four modes, the number of sectors with guaranteed restricted access in China is lower in the first two modes than in most of other countries, and essentially zero in Mode 3. In terms of national treatment, China's commitments are generally deeper and wider than those of all other country groups. (Ianchovichina et al.2001) (Table 1)

China also made certain "horizontal" commitments, which are ones that apply to all sectors listed in its services schedule. The two most important of these cross-cutting commitments involve acquired rights and the licensing process. Under the acquired rights commitment, a foreign company will be allowed to continue to operate with pre-WTO accession rights even if they went beyond the commitments made by China in its services schedule.⁵ In the licensing area, China committed to licensing procedures that were streamlined, transparent and more predictable.⁶

¹ United States General Accounting Office, Report to Congressional Committees, Analysis of China's Commitments to Other Members, October 2002

² Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

³ Overall, for China, the coverage of market access commitments (i.e. the unweighted average count) was 57.4 percent. This is much higher than the commitments offered in the Uruguay Round by any other group of countries (including high income countries). (Table 1) The "average coverage," a measure of coverage that better reflects the extent of liberalization of services, was 38 percent for China again more open than even the high income countries. The share of completely liberal commitments (i.e. no restrictions) in the maximum possible commitments was 23 percent for China, much higher than that for any other group of developing countries but somewhat lower than that for high income countries. (Ianchovichina et al.2001)

⁴ Report To Congress on China's WTO Compliance, USTR, 2002

http://www.ustr.gov/regions/china-hk-mongolia-taiwan/2002-12-11-China_WTO_compliance_report.PDF

⁵ China agreed that the conditions of ownership, operation and scope of activities for a foreign company, as set out in the respective contractual or shareholder agreement or in a license establishing or authorizing the operation or supply of services by an existing foreign service supplier, will not be made more restrictive than they were on the date of China's accession to the WTO. Report To Congress on China's WTO Compliance, USTR, 2002

⁶ Prior to China's WTO accession, foreign companies in many sectors did not have an unqualified right to apply for a license to operate in China. They could only apply for a license if they first received an invitation from the relevant Chinese regulatory authorities, and even then the decision-making process lacked transparency and was

2.2. Chinese Banking Sector Commitments

China made substantial liberalized commitments in the financial sector, of which, banking is a most prominent sub-sector. Prior to its accession to the WTO, China had allowed foreign banks to conduct foreign currency business in selected cities only. Although China had also permitted foreign banks on an experimental basis to conduct local currency business, the experiment was limited to foreign customers in two cities only.

According to China's WTO commitments, China's financial markets will be opened substantially, but through a step-by-step approach. Two years after the China's entry into WTO, foreign banks will be allowed to undertake some local currency business with all their customers. Five years after China's entry, foreign banks will be able to fully engage in local currency services and receive national treatment in banking services without restrictions in terms of geography, branching, and scope.⁷(Table 2)

2.2.1. Major Horizontal Commitments

- i. Regarding commercial presence, foreign investment in an equity joint venture should be no less than 25 percent of the registered capital; establishment of branches by foreign enterprises is boundless unless otherwise indicated in specific sectors.
- ii. Regarding presence of natural persons, senior foreign employees of a corporation are permitted for an initial term of three years.

2.2.2. Commitments on Banking Services and Other Financial Services

China has made commitments in two areas, i.e. geographic coverage and licensing:

- i. First, on geographic coverage, foreign currency businesses will have no geographic restriction upon accession. Local currency business is possible only in Shanghai, Shenzhen, Tianjin, and Dalian upon accession; within one year after accession, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan; within two years, Jinan, Fuzhou, Chengdu and Chongqing; within three years, Kunming, Beijing, and Xiamen; and within four years, Shantou, Ningbo, Shenyang, and Xi'an. There will be no more restrictions thereafter.⁸
- ii. Second, on licensing, foreign financial institutions with total assets of at least \$10 billion at the end of the year prior to filing of application may establish a subsidiary; for establishment of a branch of a foreign bank, total assets should be at least \$20 billion; and for establishment of a joint bank or a joint finance company, total assets should be at least \$ 10 billion.

2.2.3. Evolution of Chinese Banking Commitment

There have been three versions of service liberalization schedules that China prepared over its GATT/WTO negotiation period. The first one was submitted in April 1994 when China was

subject to inordinate delay and discretion. Report To Congress on China's WTO Compliance, USTR, 2002

⁷ Yun-Hwan Kim, Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues, ERD Working Paper Series No. 24, ADB, 2002

⁸ Yun-Hwan Kim, Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues, ERD Working Paper Series No. 24, ADB, 2002

participating in the Uruguay Round services negotiations. The second one was signed in 1999, well publicized for concluding its tough bilateral negotiation with United States. The third one is China's final accession Protocol, which was effective in December 2001. Each version represents different liberalization preference and scope and their evolution on banking commitments is outlined below.

i. 1994 Commitments

Under the 1994 commitments, foreign banks could only operate in specified regions, accept deposits only from non-residents and only in foreign currencies (with some exceptions), and make no loans to Chinese citizens. On accession, geographic and client limitations will be eliminated for foreign currency business. Even though the schedule states that on accession, local currency business will be allowed in 4 cities (Shanghai, Shenzhen, Tianjin and Dalian), there seems to be a binding restriction on clients which will only be relaxed with in two years. The entire banking sector will be fully liberalized by 2006.⁹

ii. 1999 Sino-US Commitments

An outstanding characteristic of Sino-US commitments in 1999 is that China agreed to significant liberalization to be implemented either immediately or in a short transitional period once China become WTO Member. Different from 1994 schedule, China has agreed to allow foreign banks to conduct local currency businesses with Chinese companies two years after its WTO accession and with Chinese individuals five years later. During the first year of WTO membership, China will also open up two additional cities for foreign banks to conduct local currency (Renminbi, RMB) business, and four new cities will subsequently be opened to foreign banks every year thereafter. All restrictions on foreign banks are to be removed five years after China's entry to the WTO.

iii. China 2001 Commitment

A notable phenomenon in China's 2001 commitments, the official accession Protocol, is that it doesn't contain significant change comparing to Sino-US commitment in 1999 in terms of the banking service. Only geographic coverage, which specified certain city liberalization order, was revised in the commitments in 2001. A minor change was made to realign the specific date to a flexible timetable accordingly to the final accession, i.e., January 1, 2002 was converted into two years after accession. (Table 3)

The evolution in Chinese commitments, though results of tough negotiation process, does provide some indication of the changing situation as well as legal and policy consideration. Sino-US commitments, that made significant step in banking sector, is a milestone in terms of China's liberalization process. Regarding the legal status, the first schedule did not have legal status since China was not a Member of the WTO.¹⁰ Though the second one contains again no legal value before China becomes WTO Member, it however provides a time reference for policy evaluation. Chinese commitments under the GATS in 2001 obviously have legal status as part of its accession protocol.

2.2.4 Debate Over Chinese Banking Commitments

⁹ Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

¹⁰ Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

The Chinese banking liberalization commitments have received wide attention internationally and some criticism from domestic opinions. The role of open financial markets has become a subject of debate and a controversial issue since the onset of the Asian crisis in 1997. As we stated earlier, Sino-US agreement in 1999 was signed shortly after the Asian financial crisis. It was naturally debatable on the appropriateness of such progressive commitments.

The primary reason for those views lies in the huge Chinese NPLs on the one hand, and the schedule of full liberalization within five years, on the other hand. The official figure for NPLs of the big four state-owned commercial banks is about 25 percent of the total loan portfolio. This excludes the 10 percent equivalent of total portfolio NPLs that were transferred to the four Asset Management Companies established in 1999.¹¹ Another concern is the decline in the profitability of local banks after China liberalizes its banking sector. Some high-quality clients with good creditworthiness, particularly those located in the more developed coastal areas, will likely shift to foreign banks, leaving the less creditworthy clients and some policy-based business with the domestic banks. This probable shift is a major threat to the domestic banks.¹²

More rigorously, leading international rating agencies estimated that the big four commercial banks in China possessed huge NPL of over USD120.8 billion, equal to 12 percent of GDP in 1998. For the entire banking system, the total NPL would be approximately 25-40 percent of the total credit extension of USD1 trillion. Meanwhile, bond issues of the Big Fours were rated as junk bonds in the world financial market. Despite holding the largest market shares, the state banks in China were unable to make the most of their strengths. NPL gradually accumulated to over USD 500 billion, or about 50 percent of GDP¹³.

III. POLICY ANALYSIS: INTERACTIVE ROLE OF WTO AND CHINA ECONOMIC REFORM OF CHINESE BANKING REFORM

Given the huge NPL, the decision that China made on banking liberalization deserves careful consideration. Without analyzing the underlying Chinese economic environment at the time when China made the commitment, it would be hard to interpret why China took this rigorous commitment. Since China's 2001 WTO Accession Protocol largely evolved from Sino-US WTO agreement in 1999, the benchmark year of this paper is therefore set in 1998, i.e. one year before the Sino-US agreement.

3. 1. Rationale of Chinese Banking Reform

3.1.1. Impetus of Banking/Enterprises Reform after Asian Financial Crisis

i. Serious Financial Environment

The external risk of financial turmoil reached the peak in China in 1997, due to the Asian financial crisis that swamped Thailand, Indonesia, Korea, etc. It accentuated the slowdown of growth that

¹¹ Yun-Hwan Kim, Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues, ERD Working Paper Series No. 24, ADB, 2002

¹² Yun-Hwan Kim, Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues, ERD Working Paper Series No. 24, ADB, 2002

¹³ Chinese Banking Sector: More AMC Establishment to Handle NPL Problems, November 11, 1999

had followed the boom of the early 1990s in China. The stability of China's currency became a hot issue. There was sharp falling demand for exports compounded by weakening domestic consumption. Internally, the weakness of the Chinese banking system was suddenly exposed. A lot of the key problems in the troubled Asian economies can be easily identified in China, such as a fragile banking system, huge policy directed lending, insufficient prudential provisions and a buoyant property market.¹⁴ The large proportion of NPL in China, as stated earlier, was much higher compared that in pre-crisis affected countries like Thailand (15 per cent), South Korea (16 per cent), Indonesia (12 per cent) and Malaysia (7 per cent). The total outstanding loans of the Chinese state commercial banks (SCBs) were 6,610 billion yuan before Asian financial crisis. It implied a total of 400 billion yuan bad debts in China's banking sector, which was greater than the banks' net assets, 317 billion yuan. The SCBs were, therefore, technically insolvent.¹⁵

China recognized that the profound structural financial reforms couldn't be delayed in the wake of the Asian financial crisis, though restriction of capital account financial market limited contagion for susceptible China's banks.¹⁶ With the new reform initiatives China launched immediately, China was trying to ensure its financial stability by speeding up banking reform, reduce bad debts by RMB 60 billion annually and rectify stock market excesses.¹⁷ The strategy has been to relieve the SCBs of the responsibility for policy lending, while placing their operations on a commercial footing and holding them accountable for new lending decisions. In pursuit of these goals a wide range of measures were taken, including moving policy lending to newly created policy banks, restructuring the People's Bank of China, abolishing the credit plan, partially recapitalizing SCBs and transferring part of their NPLs to asset management companies (AMCs)¹⁸, strengthening the prudential framework.¹⁹

However, these attempts largely turned out to be a failure as new bad loans continued to accumulate. "Moral hazard" problems were created and spread. Clearly, additional steps must be taken besides recapitalization and restructuring of domestic banking system to avoid a deepening domestic banking crisis.

ii. Underlying Problem: Banks vs. Enterprises

The banking reform actually has been dragged by the performance of the client enterprises, particularly state-owned-enterprises (SOEs). Non-productive SOEs largely account for NPLs since SCBs lending is strongly biased in favor of SOEs. There is long-standing practice of making lending decisions in favor of SOEs and planned projects for political reasons without due diligence and necessary economic considerations.

As mentioned above, there are four big largest state commercial banks dominating deposits and lending activities in China, i.e. Industrial and Commercial Bank of China, the Bank of China, the

¹⁴ Warwich J.Mckibbin, *The Global Impacts of Trade and Financial Reform in China*, 1998

¹⁵ Yiping Huang, *Challenges for China's financial reform*, The Australian National University, China Update Conference, 1998

¹⁶ Nicholas R. Lardy, *China's Unfinished Economic Revolution*, Brookings Institution Press 1998, c. 342pp.

¹⁷ China Speeding up banking reform, WTO Corner, the Bulletin, October 2001 Issue, www.chamber.org.hk/info/the_bulletin/oct2001/wto.asp

¹⁸ In 1999, the State Council approved the establishment of the four bank Asset Management Companies which each acquired significant assets from one of the four state-owned commercial banks. (Orient AMC o BOC, Great Wall AMC to ABC, Huarong AMC to ICBC, and Xinda AMC to CCB). Source: HSBC Securities (2001)

¹⁹ China Competing in the Global Economy, edited by Wanda Tseng and Markus Rodlauer, Feb 24, 2003. www.imf.org/external/pubs/nft/2003/china/index.htm

Construction Bank of China and the Agriculture Bank of China (“The Big Four”). They together account for about 80 percent of all deposits in the banking system and a somewhat lower, but still dominant, share of all lending (directly or indirectly through subsidiaries). However, due to so many of their major SOE customers are failing commercially (while many continue to operate to protect employment), the “Big Four” are operated inefficiently and their performance have become increasingly poor over the years in terms of profitability.²⁰ The annual circulation rate of bank loans was very low and fell consistently in the 1990s, from 1.32 in 1993 to 1.07 in 1996 (Table 4). This was significantly lower than that was achieved in many Asian economies before the financial crisis in 1997. Total profits of the Big Four also dropped consistently, from 34.3 billion yuan in 1992 to 19.6 billion yuan in 1996. The average profit-to-net asset ratio was 5.6 per cent in 1996. The net profit rate could be turned to a net loss if the uncollected interest payments were not counted as revenues. In 1996, the Big Four only collected about 60 per cent of the due interest payments.²¹

In particular, the reform of the SOEs poses a dilemma for a banking system that is torn between the need to avoid heavy financial liabilities and the burden of providing continued support to inefficient state-owned enterprises. The reform implies necessarily to rationalize the relationship between the government, its banking system and the state-owned enterprises and end the economically unjustified lending policy and practices. Moreover, this interactive relationship is one of the key issues that should be highlighted in the Chinese economic reform agenda. It is essential to undertake the reform of the SCBs alongside reform of the SOEs to maintain macroeconomic stability and laying a more solid foundation for long-term growth.

3.1.2. Theoretical Basis for Sustainable Reform

China is facing an immense challenge in its economic reform. The reform efforts on SCBs involve huge cost such as China three-year bail-out SOEs plan²² and transmission NPLs to AMC. With the less than satisfactory outcome of these two reforms, questions remain as to whether the national-wide unprecedented economic reform would be undertaken in a sustainable manner.

Investment choices theory highlights the relationship between fixed cost and marginal return for the purpose of decision-making. It suggests that when making a decision involving huge amount of fixed investment, it requires an expected increasing marginal return within a reasonable period. This theory bears an analogy to an economic reform decision in general, and Chinese banking and enterprises reform in particular. If the cost associated with banking and SOE reform is viewed as a heavy fixed investment cost, the rationale for the reform decision or the plausible direction to achieve is to, either foresee or promote *accelerating* revenues generated by profitable enterprises (marginal return) to offset the enormous reforming cost (fixed cost). The fixed reform investment is viewed as static cost while future enterprises profits can be viewed as dynamically evolving benefits. The whole domestic reform would be sustainable under the premise of increasing dynamic benefits from enterprises.

²⁰ Pieter Bottelier, *WTO and the Reform of China's Financial Sector*, Discussion Note for the Second Annual Conference on Change in Contemporary China of the Center for China-United States Cooperation of the University of Denver: “China’s Entry into the WTO: Winners, Losers, Implications” – Vail, Colorado, May 25-26 2001)

²¹ Yiping Huang, Challenges for China’s Financial Reform, ANU, Paper presented to China Update, 3 August 1998
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²² People’s Daily, China, 2001/03/08

It is logical to consider that when Chinese government took the decision to bear huge banking and SOEs reform cost, e.g. transferring the NPL to AMC, it has no alternative but to mobilize all the efforts to accelerate marginal benefits generated from enterprises to equalize or outweigh the reform cost. However, when one views back at the glooming picture of the deadlocked relationship between Chinese SCBs and SOEs, it is doubtful if there is any real chance for the cost offsetting since Chinese SOEs remained inefficient and there is little hope for a fundamental change within a short term. Even worse, there is potential threat that a number of SOEs might be going bankrupt and extinguished under more stringent borrowing conditions, which would put in turn more pressure on the fragile banking system.

3.1.3. Comparison of Three Categories of Enterprises and Dynamics of Private Sector

Where is then the likely potential source of enterprises from which marginal benefits may come from? Overall, Chinese enterprises are composed of three major categories according to their ownership: SOEs, foreign-owned-enterprises (FOEs) and domestic private sector. The comparison in terms of endowment and economic performance among these three types of enterprises may provide some indications on the potential sources for the increasing benefits.

i. Endowment and Economic Performance Comparison

- In terms of financial endowment and economic performance, SOEs take nearly 80 percent of the bank loans while producing only one-third of the country's GDP. FOEs, sourcing financial investment internationally rather than domestically, brought about a large share of profits in China. In comparison, Chinese private enterprises contribute 30% of total GDP in 1999, however, only 1% of private enterprises financing comes from bank lending and only 1% of listed companies on Shanghai and Shenzhen exchanges are private enterprises (Langlois, 2001). Table 5 shows that the SOE's share of industrial production has been declining. It tells that the SOE's industrial output has declined in relative terms, while their investment share remained largely unchanged. This implies that the investment efficiency has been deteriorating.²³
- In terms of policy treatment, the rights that three major players enjoy are tremendously different. SOEs, representing public sector interest groups, obviously enjoy most preferential means by the government, i.e., subsidized input of production. FOEs, under the Chinese FDI promotion policy, were provided with a series of favorable treatments such as tax exemption, tax holidays, discounted real estate, etc. The most common preferential policy for FOEs is tax exemption for two years followed by 50% reduction for three more years.²⁴ Upon approval by the tax authorities, production FOEs with a period of operation of 10 years or more shall, commencing with its first profit-making tax year, be exempt from enterprise income tax for the first and second year, and be granted a 50% reduction in its income tax rates for the third to fifth year. The domestic private sector, however, was treated in a rather discriminative manner in terms of legislation, tax policy, ability to access financial resources, etc.
- In terms of market access, SOEs dominate many key industries in spite of their declining

²³ Katsuji Nakagane, SOE Reform and Privatization in China—A Note on Several Theoretical and Empirical Issues, University of Tokyo, CIRJE-F-95, 2000.

²⁴ Article 8 of the Income Tax Law of the People's Republic of China Concerning Foreign Investment Enterprises and Foreign Enterprises

importance in the national output. They leave few space for private sector to entry in most service sectors, i.e., transportation, financial service, telecommunication, etc. Chinese SOEs accounted for nearly 100 per cent of market share in railways, civil aviation, post and telecommunications and 75 per cent in financial services, electrical power, coal, petroleum industries prior to WTO accession. These industries are the ones in which SOEs exercise monopoly power significantly.²⁵ For instance, banking regulations have restricted private sector participation for a long period of time. The consequence of retaining high entry barrier would perpetuate the inefficiencies in those sectors with high opportunity considering a long waiting list of firms for access.

- In terms of social contribution, state-owned sector and non-public sector (including foreign-owned sector and private sector) play different functions in the Chinese economy. According to China Statistical Yearbook, between 1990 and 1998, urban employment created by non-public sector accounted for 5.7% in 1990 only, but rose dramatically to 46.7% in 1998. However, the share of SOEs, the major users of national resources, decreased from 62.3% of total urban employment in 1990 to 43.8% in 1998 (Table 5). This shows clearly how private sector and other non-state enterprises have flourished in the Chinese economy, particularly in the 1990s.

ii. Dynamics of Private enterprises

Despite its lack of access to domestic bank credit and unfavorable treatment, China's private sector has been the most dynamic part of the economy. This rapid growth has occurred with relatively few resources from the financial sector: in the period 1991-1997, the share of private investment in the national total was in the range of 15-27 percent, with little recourse to formal bank loans (less than 1 percent of working capital loans went to the private sector). In addition, private firms' access to equity markets has been limited by the quota system (abolished in early 2000) and size requirements. The International Finance Corporation (IFC) (2000) reported that, of the 976 companies listed on the Shanghai and Shenzhen stock exchanges, only 11 were private firms, while in 1998 and 1999 only four private firms were listed.²⁶ Based on evidence from a sample survey, the IFC found that private firms in China tend to rely primarily on internal sources of financing—including retained earnings and principal-owner financing—both for start-up capital and subsequent investments.²⁷

Among these three categories of Chinese enterprises, SOEs's economic performance have been generally poor, FOEs performance have been fair with a large amount of preferential treatments, and the domestic private sector, strikingly, has shown strong potential with remarkable economic performance though under unfavorable conditions compared to both SOEs and FOEs in the same playing field. Based on the investment choices theory applied to the economic reform in China, the domestic private sector would be the major potential source for increasing marginal benefits that are necessary to sustain the Chinese banking reform. The potential would be fully exploited when the private sector is granted no less favorably endowment that other players enjoyed. FOEs would be the second major sources of increasing marginal benefits.

²⁵ Yongzheng Yang, *The Political Economy of Trade Liberalization in China*, Asia Pacific Press at the ANU, 1999

²⁶ The figures are quoted from IFC (2000).

²⁷ Jahangir Aziz and Christoph Duenwald, *Growth-Financial Intermediation Nexus in China*, IMF, 2002, WP/02/194

3.1.4. Key Development Barriers and Economic Reform Direction

Though emerging, under the unfavorable treatment, China's domestic private sector still has limited role to sustain Chinese banking reform, considering its total weight at only 30% of GDP. From nationwide reform perspective, the identification and removal of the barriers for private sector development would be the first priority for China policy makers in order to enlarge the private sector's economic weights.

At the national level, the key barrier for economic growth is financial resource misallocation which is the biggest efficiency loss for China. Evidences show China's system of financial intermediation is inefficient at converting financial resources into productive investment.²⁸ This illustrates the urgency for China to allocate the resource in an efficient manner.

- The banking deposit base is very large. China's high national saving rate—averaging about 40 percent of GDP in recent years, one of the highest in the world—combined with a lack of alternative financial assets has created a large deposit base, and thus a deep source of funds for bank lending.
- China's large pool of savings has been almost wholly intermediated through the domestic banking system, and, in large part, has been allocated to the SOEs. The private sector appears to have financed itself mainly out of retained earnings or principal-owner savings, as well as FOEs, rather than from bank credit or the capital markets.
- Financial intermediation in China is largely bank-based and dominated by four SCBs, with securities markets (bond and equity) still relatively small. The SCBs together account for two-thirds of financial system assets. A large proportion of savings continues to be channeled to SOEs, with state bank claims on SOEs still amounting to two-thirds of GDP at end-2000.²⁹ (Table 6)

At a sector level, as indicated above, unfavorable treatments for domestic private sector, as compared to SOEs and FOEs, are widely applied. Restricted access by the private sector to the funds has distorted credit allocation in which the state sector benefits at the expense of the private sector.³⁰ Most of the legislation and customary rule, i.e., inaccessible financial resources, market access barriers, higher tax rate, etc, impede private sector growth significantly. The reform agenda should therefore include removing investment barriers, streamlining the financial channel, equalizing the tax policy, etc.

In addition, the emergence of private-owned banks are highly desirable. The merits are similar with foreign banks' entry. First, the entry of private-owned banks facilitates competition by ending the monopoly of major SCBs. Creating a competitive environment will improve efficiency, innovation, and development of new services. Second, development of private banks will help address the distortion in credit allocation in which the state sector benefits at the expense of the private sector, particularly small and medium enterprises. If a private sector banking system is

²⁸ Jahangir Aziz and Christoph Duenwald, Growth-Financial Intermediation Nexus in China, IMF, 2002, WP/02/194 P 6

²⁹ Jahangir Aziz and Christoph Duenwald, Growth-Financial Intermediation Nexus in China, IMF, 2002, WP/02/194

³⁰ Kim Yun-Hwan, *Financial Opening Under the WTO Agreement in Selected Asian Countries Progress and Issues*, ADB working paper No.24, 2002)

developed, SMEs, private sectors and FOEs will have better access to bank credit.³¹

By examining financial situations externally and internally, this Section reveals that there was endogenous and urgent need for China to conduct banking reform since Chinese financial resources misallocation became major encumbrance for the economic development. In order to promote Chinese economic reform in a sustainable manner, China has to remove those barriers to enable Chinese enterprise development especially the growth driven domestic private sector. The direction of reform, from a long-term perspective, would be creating a fair environment for competition among all categories of enterprises.

3.2. Why Pursuing Economic Reform Objective through WTO?

From an endogenous perspective, it should be first priority for China to take direct reform decision. The approach China chose, however, is a puzzle. There were at least two options for China to tackle with those development barriers. The first option would be tackle those tough issues through domestic reform in a direct and confrontational manner. The second option would be liberalizing banking system following the momentum of its accession to the WTO.

Based on the optimal policy theorem, the first-best policy is to address the divergence at its source directly.³² The first option, which is to remove the identified development barriers, is actually the first-best policy for China. The objective is to correct the market failure, and enable three types of players compete equally in terms of resources allocation to achieve Pareto efficiency. Any postponement or policy reversal may lead ongoing banking and SOEs reform unpredictable or even to failure. However, rather than tackling the problems directly, China intentionally chose to forgo the “best” option and to pursue its agenda through the dynamics of WTO accession---a second-best solution on existing problems. How to interpret this apparent puzzling approach, and what are the underlying political, economic and other policy considerations?

3.2.1. Political considerations

i. Lock-in-reform

Chinese WTO accession strategy put much weight on the benefits of service trade liberalization and on the difficulty of securing them because of the risks of policy reversals and a return to protectionism. Observing carefully, services sectors are the major field within the economy that contains largest entry-barriers for foreigners as well as for domestic private sector. By claiming the key-to-economic-sovereignty, inefficient Chinese SOEs were lobbying the Government successfully to maintain their domination in nearly all fields of the service sectors, e.g., financial service, telecommunication, transportation, etc. In their interests, these SOEs naturally intend to block any further attempt of economic reform and hedge themselves from the competition.

WTO Accession provides a unique opportunity for the Chinese Government to liberalize the economy and lock in these series of reforms. By committing itself internationally, WTO bindings make it easier for Chinese government to undertake the comprehensive economic reform policy rather than a discretionary trade policy that caters to the special interests of well-organized groups.

³¹ Kim Yun-Hwan, *Financial Opening Under the WTO Agreement in Selected Asian Countries Progress and Issues*, ADB working paper No.24, 2002)

³² Jaime De Melo, *Trade Policy Under Externalities*, University of Geneva, 2001

It also provides political cover for Chinese government in its efforts to resist protectionist forces.³³

ii. Least-Political-risk. Considering the new round of forthcoming reform package, giving domestic private sector equal treatment may reshape fundamentally current landscape of financial system and economic composition. It is likely to start with reallocation of the resources from existing beneficiaries, mostly SOEs to more efficient users according to market criteria, and gradually remove the entry-barrier for private sector to establish private banks. It may even lead to *de facto* nationwide privatization as market mechanism plays fully its role, which could be most efficient resource allocation strategy.

However, reform advocators may face unexpected political chaos, because the term of *privatization* is still a taboo in the Chinese political nomenclature today. There may still be the risk of turning back the whole economic reform process completely under strong political pressure. Banking reform would be the most sensible frontier to be affected. As the reforms proceed, policy-makers must seek the safest haven to avoid any potential turmoil for its weak Chinese financial system. Chinese WTO accession, though with possibly more concessions than it would have to, is politically desirable as the second-best choice for Chinese authority to undertake the unprecedented national reform.

3.2.2. Economic considerations

i. Competition is least-cost way to achieve reform objective. There are two-way competition pressures on SCBs, one is at the source, and the other is at the level of the users. In terms of deposits, when well-organized foreign banks entering into Chinese market, it is likely to see the immense Chinese households deposits shift from SCBs to foreign bank and put severe pressure on SCBs to improve its service and efficiency. At the users level, SCBs will face severe competition on good users that may force it change their lending regulation to an efficient way. Under the competition pressure, the market will build up a new channel for good-performance private sector and FOEs to access the important financial resource which would not be available otherwise. It may naturally solve the problem for private sector to be equally treated to access the financial resources and make use of the social resources efficiently. In other words, private sector's access to equity and debt financing will be enhanced. Therefore, without spending additional social resources, competition instrument becomes the least-cost mean to achieve the reform objective through a market-oriented approach. As perfect competition is one of the major assumptions in mainstream of economic theory, the economic theory consensually suggests that competition is most effective and least-cost approach to achieve optimal efficiency. Therefore, it turns out to be more economically desirable to conduct the reform through the second option, i.e. promoting reform agenda through WTO accession.

ii. Channeling savings to the non-state sector. As foreign banks enter into Chinese market, it is likely to see the deposit to shift to foreign banks from domestic banks. Private sector will have better access as long as it meets banks lending criteria. The problem for private sector in terms of the financial resources access will be eased. This will allow financial sector in China to play the role of efficient intermediary between savers and borrowers, and thus strengthen the positive link between financial development and economic growth.

³³ Jaime De Melo, Trade Policy Under Externality, University of Geneva, 2001

iii. The value of an open banking sector. Competitive banking sector services lie in its ability to transform the pool of savings into investments. The deepening of financial reform in China will have aided growth by allocating savings more efficiently rather than simply making more savings available for investment purposes.³⁴ More open banking assures efficient allocation of financial resources to a highest rate of return and greater benefits to the overall economy.³⁵ Empirical evidence shows that increased competitiveness through financial sector openness enhances economic growth. Increased competition may imply a reduction in domestic bank profits, but banking customers will gain through reduced net interest margins, lower costs of fee-based services and the availability of a greater variety of services.³⁶

iv. Well functioning service industries contribute to goods production. Production of services is often input into production of goods. Inefficient production of services acts as a tax on goods production. It underpins economic development efforts, because more efficient provision of service in finance has broad linkage effects.³⁷ The multiplier effect of increasing competition in the banking sector will reduce business costs and improve the quality of the financial instruments available to the business community. An efficient financial sector allows resources to be deployed where they have the highest returns. Efficient financial service contributes to and precedes faster economic growth (King and Levine 1993). Delays to open these financial services, especially geographically, will actually tax Chinese businessman.³⁸

This section explores the endogenous need for China to conduct banking reforms through the comparison among SOEs, FOEs and private sector. It further figures out the political and economic rationale for China to address the development barriers through WTO accession. The political considerations are mainly two folds: i.e., lock-in reform and least-political-risk. The economic rationale of banking sector liberalization implies that China's WTO commitment will lead to unambiguous benefits in several ways, such as creating competition environment; facilitating resource mobilization to non-state-sector; helping to improve resource allocation, thereby enhancing total factor productivity (mostly of capital); and lower the input of goods production.

IV. LEGAL ANALYSIS OF CHINESE BANKING COMMITMENT AND LIBERALIZATION

Though the dynamics of China's economic reform clearly illustrates the compatibility of the banking reform with WTO requirement, one may wonder if GATS obligations exceeded what China's willingness to concede and what China could afford to implement. The major concerns in financial services internationalization are: the threat to the survival of local banks and financial companies; the loss of monetary autonomy; and the increased volatility of capital flows.³⁹ Two

³⁴ Jahangir Aziz and Christoph Duenwald, Growth-Financial Intermediation Nexus in China, IMF, 2002, WP/02/194

³⁵ Robert B. Cassidy, Trade in Services in China: Implementing the WTO, The National Bureau of Asian Research, 2002

³⁶ Risk and Benefits for Developing countries Banking Systems from the Internationalization of Financial Services, WTO and World Bank, 2001

³⁷ Service negotiations offer real opportunities for all WTO members and more so for developing countries, WTO News: 28 June 2002

³⁸ Robert B. Cassidy, Trade in Services in China: Implementing the WTO, The National Bureau of Asian Research, 2002

³⁹ Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

issues therefore deserve careful examination: First, what's the implication of legal requirement on banking under the GATS? Second, how Chinese domestic legislation responded and evolved after WTO accession? What are the impacts on banks especially foreign banks? And are these legislations are WTO-compliant?

4.1. Implication of GATS Legal Provisions on Banking

In order to appropriately evaluate the generally suspicious view on Chinese banking commitments, one has to read Chinese commitment from the perspective of the right on domestic surveillance and macroeconomic stability. The extent of the freedom depends primarily on the level of flexibility inherent in the mandatory provisions of GATS. The assessment of freedom for China to impose restrictions on financial service, therefore, should start with GATS provisions in terms of the scope and the obligations.

4.1.1. Scope of the Coverage

There have been concerns on the risks of capital account liberalization, especially after Asian financial crisis. These concerns are due to confusion on the coverage of GATS. Financial services trade liberalization under the GATS and the opening of the capital account are two distinct issues. The GATS does not require full capital account liberalization, but focuses on seeking improvements on market access and non-discriminatory treatment for foreign suppliers of financial services. It requires only limited liberalization of capital movements in the context of financial services trade liberalization.

It is true that Members are required to allow international transfers and payments for transactions relating to their specific commitments under the GATS, some of which may involve capital account transaction, as Article XI of the GATS stipulates:

"...except under circumstances envisaged in Article XII (described below), a Member shall not apply restrictions on international transfers and payments for current transactions relating to its specific commitments (Article XI:1)."

Furthermore, Article XI: 2 provides that:

"Nothing ..., provided that a Member shall not impose restrictions on any capital transactions inconsistently with its specific commitments regarding such transactions, except under Article XII or at the request of the Fund."

However, Footnote 8 to Article XVI would, narrow the range of circumstances in which a Member is obliged to allow capital transactions (Mattoo, 2003). This footnote states:

"If a Member undertakes a market access commitment in relation to the cross-border supply of a service and if the cross-border movement of capital is an essential part of the service itself, that Member is committed to allow such movement of capital. If a Member undertakes a market access commitment in relation to the supply of a service through commercial presence, that Member is committed to allow related inflows of capital into its territory."

Normally, financial services are provided in two ways: cross-border (Mode 1) and through the presence of a foreign establishment (Mode 3). Thus the footnote relieves Members of obligations

with respect to capital flows related to consumption abroad, and with respect to capital *outflows* related to commercial presence.⁴⁰ It is particularly important for a developing country like China where domestic financial markets remain underdeveloped and vulnerable to external environment. It implies that the GATS requires only the liberalization of capital flows in the financial services provided by foreign financial institutions. Commitments to cross-border trade liberalization (Mode 1) require the liberalization of capital inflows and outflows which are an "essential part of the (liberalized) service", while commitments to commercial presence (Mode 3) require the liberalization of capital *inflows* which are "related to the supply of the service" without specifying in more detail whether this refers only to capital and equipment to "set up shop" or whether this also includes capital inflows related to service provision.⁴¹ Capital *outflows* related to the supply of services by foreign establishments under Mode 3 do not have to be liberalized under GATS (Kono and Schuknecht 2000).

A simple example may help to illustrate the distinction between capital account liberalization and financial service liberalization under the GATS. A lending service, for instance, can be provided by either domestic bank or foreign financial presence in the territory of this country. If a domestic bank provides a loan to a domestic client using domestic capital, it creates neither financial services trade nor an international capital flow. If a domestic bank lends capital from abroad to the domestic client, this is a case of capital flows without financial services trade. A loan arranged by a foreign institution commercial presence involving only domestic capital is an incidence of financial services trade without international capital flows. Only loans through a foreign bank commercial presence involving international capital, represent international capital flows and trade in financial services. Table 7 provides an example on differences between capital account liberalization and financial service liberalization under the GATS.⁴²

4.1.2. Non-discrimination Requirement

The GATS essentially takes the central non-discrimination concepts of the GATT system, i.e., Most-favored-nation (MFN) and national treatment (NT), and applies them to the realm of services trade. However, there are fundamental differences in terms of application under GATT and GATS. In GATT, both MFN and NT are general or unconditional obligations whereby the GATS sets out general (unconditional) MFN and specific (conditional) NT.

i. MFN

Article II of the GATS, MFN, constitutes a general obligation which is in principle, applicable across the board by all Members to all service sectors. It is a general obligation under both GATT and GATS. Article II:1 of the GATS states:

“With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.”

⁴⁰ Aaditya Mattoo, *China's Accession to the WTO: The Services Dimension*, The World Bank, 2003

⁴¹ See GATS Article XVI, Footnote 8. What constitutes an "essential part of the service" for mode 1 trade and an "inflow related to the supply of the service" under mode 3 trade is not further specified.

⁴² Yun-Hwan Kim, *Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues*, ERD Working Paper Series No. 24, ADB, 2002

Article II: 2 sets the provision to allow a Member to maintain exemptions to MFN treatment with certain conditions. Such exemptions, however, had to be taken at the time the negotiations were concluded. Article II: 2 states:

“A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.”

Financial sector is a sensitive sector in many countries. Though MFN exceptions are allowed to be listed under the GATS, surprisingly, financial service including banking, is not subject to China's MFN exemption. However, MFN exemptions in financial services were clearly identified in not only developing countries such as Indonesia, Pakistan, Singapore, South Africa, Venezuela, but also many developed countries such as United States, Switzerland, Canada and European Union (and its Member States). (Table 8)

ii. National Treatment

In contrast to the traditional GATT fashion, National Treatment in GATS (Article XVII) is specific and conditional. It is “positive list” approaches that apply only to sectors explicitly included by a Member in its schedule of commitments. Specifically speaking, Members may inscribe limitations on national treatment in their schedules with respect to each of the four modes of supply.⁴³ Article XVII states:

“In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect to all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.”

Since NT applies only to sectors explicitly included in the Schedule, when examining Chinese banking liberalization, one has to examine Chinese Accession Protocol. Equally surprising, there are few limitations on national treatment in its Schedule. It focuses on market access instead. China's commitments are deeper and wider than that of all other country groups in terms of national treatment (Ianchovichina et al.2001). Specifically, China inscribes “None” to nearly all of the “Banking and Other Financial Services (excluding insurance and securities)” in its Schedule on National Treatment. Combing the obligation on MFN, these settings imply that China has given up the right to offer preferential treatment to domestic banking through *any measure* affecting the supply of banking services for the most part.⁴⁴

WTO commitment presents a unique role on Chinese economic reform in China. The underlying concerns behind NT commitment in China may be surprising. Actually, China creatively applies the National Treatment provisions to tackle its domestic access barriers on private sector. Generally speaking, there are 2-layers impediments to efficiency that called for WTO national treatments. The first layer is the entry barrier between domestic monopolies versus foreign investors. The second layer is the entry barrier between foreign investors versus domestic private sector. This has led to a unique concept of “Chinese National Treatment”, which means not to treat domestic private sector less favorable than foreign counterpart. WTO accession, therefore, plays an intangible role to stimulate the domestic reform, which leads to an accelerated privatization by

⁴³ Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

⁴⁴ Aaditya Mattoo, China's Accession to the WTO: The Services Dimension, The World Bank, 2003

creating a competitive market for three types of business players equally, i.e., SOEs, FOEs and domestic private sector. With a competitive playing field and sound legislation system, China benefits from its decision on WTO accession.

4.1.3. GATS Provisions related to Maintaining National Financial Sovereignty

i. Prudential Regulation

There is an important Annex of the GATS, Financial Services Annex, which envisages a general exception to the implementation of GATS commitments in terms of financial service. This provision is particularly meaningful when interpreting Chinese financial service commitment and domestic legislation. Paragraph 2(a) of Financial Services Annex states:

"Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system."

Prudential "carve-out" is an exception rule to ensure governments to protect the financial system and its users. (WTO Secretariat, 1999) Article VI of the GATS, as a general rule, requires that the domestic regulation shall be "administered in a reasonable, objective and impartial manner," and that states shall enter into consultation for the elimination of unnecessary regulatory barriers to trade. However, Financial Services Annex limits this requirement, by allowing Members to freely undertake "prudential" regulation for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system, provided not be used as a means of avoiding commitments or obligations under the Agreement.

The said Annex also clarifies prudential measures that need not be inscribed in Members' schedules of specific commitments, as they are not regarded as limitations on market access or national treatment. (Mattoo, 1998) Moreover, the Annex does not define prudential measures or provide an indicative list of such measures.

It is well known that liberalization of financial services trade requires careful preparation. Liberalization of financial services trade itself does not cause financial crises but, in the presence of inadequate macroeconomic and regulatory policies, it can exacerbate problems. The importance of this prudential provision is to grant the Member full right to seek the financial stability. Any effort serving for this purpose is fully recognized by the WTO. With a weakly managed financial system, China certainly needs and has to take more prudential measures to tackle its own banking problem. Measures consistent with this provision may include capital adequacy ratios, restrictions on credit concentration or portfolio allocation, and disclosure and reporting requirements, as well as licensing criteria imposed on financial institutions which are not more burdensome than necessary to ensure the solvency and the healthy operation of those institutions⁴⁵.

ii. Macroeconomic Policy Management.

⁴⁵ Special Studies opening markets in Financial Services and the Role of the GATS, World Trade Organization, embargo Until 0001 GMT 22 September 1997

When a central bank conducts open market operations, for example, conditions in the financial sector could be affected through the impact of such interventions on the money supply, interest rates or exchange rates. It is notable that services supplied in the exercise of governmental authority, including activities conducted by a central bank or monetary authority or by any other public entity in pursuit of monetary or exchange rate policies, are excluded from the scope of the GATS.⁴⁶ Furthermore, a wide range of measures for macroeconomic management, such as reserve requirements on banks, could presumably be justified as measures to ensure the integrity and stability of the financial system under the terms of the Annex on Financial Services.

iii. Other Regulations

In the case that a Member faces serious balance of payments (BOPs) and external financial difficulties or the threat thereof, it is entitled under Article XII of the GATS to maintain temporary restrictions on trade in services in respect of which it has assumed commitments, including on payments and transfers for transactions related to such commitments.⁴⁷

As a summary, when answering the question whether China liberalizes its banking sector completely or partially or how far did China go in its commitments, GATS provisions may serve for a good understanding. The GATS does not require an individual Member to compromise the ability of governments to pursue sound macroeconomic and regulatory policies⁴⁸ although China commits itself to a very liberalized manner. The major safety valve GATS provides which allows China to maintain the national financial sovereignty through the provisions are summarized as below:

- GATS commitments of countries would not affect their ability to engage in macro-economic policy management in general and that these fall outside the ambit of the GATS;
- Through prudential regulations Member states could protect their financial sectors, and the stability of the economy and welfare of consumers - such as capital adequacy ratios and solvency margin requirements, restrictions on credit concentration or portfolio allocation, requirements for preserving asset quality, liquidity ratios, controls on market risk, management controls and disclosure and reporting requirements;
- Member can maintain other regulations, not prudential in nature, that can affect conditions of operation and competition in a market - such as requirement for lending to certain sectors or individuals, and on the basis of preferential rates;
- GATS allows countries (Art. XVI and XVII) to protect their financial sectors from excessive competition from foreign firms; and
- The GATS Balance-Of-Payments provisions (Art. XII) enable a country to impose temporary restrictions on trade in services, involving non-fulfillment of commitments under GATS.⁴⁹

Therefore, legally speaking, there is sufficient flexibility for China to regulate its domestic

⁴⁶ Under Article I:3 of the GATS and the Annex on Financial Services.

⁴⁷ Special Studies opening markets in Financial Services and the Role of the GATS, World Trade Organization, embargo Until 0001 GMT 22 September 1997 P 23

⁴⁸ See Kono et al. for a more detailed discussion (1997).

⁴⁹ WTO secretariat report

financing regulations under the GATS. WTO Members are free to establish own legal standard on banking.⁵⁰ The next question to be addressed for China is how domestic legislation should be drafted to secure a successful reform in its banking system.⁵¹

4.2. Chinese Banking Regulations Development and its Implication

WTO recognizes that while Member conducts its liberalization, complemented regulations are legally sound and necessary. This is particularly important for China, a Member with weak financial system. Failure to do so may cause financial turmoil. It should not be a sequence issue but a simultaneous conduct between liberalization and regulation. This section addresses the weakness of Chinese legal system on banking and presents new regulations that China promulgates in response to the WTO commitment, which effectively put the pressure from foreign banks under the controls.

4.2.1. Major Weakness of Chinese Legal System on Banking

There were a number of weaknesses in Chinese legal and regulatory system before its WTO accession, which may hamper financial sector development. Firstly, there were many gaps or gray areas where no suitable laws or subordinate legislation could apply. For instance, there was no legal framework for handling bankruptcy of financial institutions, nor were there regulations governing electronic transactions, antimony laundering, and nonblank financial companies, such as trust and investment companies, finance and leasing companies, etc., as they were regulated by various regulations and degrees. Secondly, a consistent and effective approach in enacting and amending laws was also lacking, as well as transparent procedures to bring in stakeholders' participation into the legislation process. Thirdly, enforcement laws and regulations were inadequate and on many occasions, financial sector supervisors would have to rely on the interpretation of the Supreme Court when implementing the law. Fourthly, the segregated regulatory system had overemphasized the regulations of market behaviors compared with the prudential regulations of financial institution. Prudential supervision proves to be more difficult in a segregated system where financial institutions are engaged in cross-sector activities. There was no mechanism in China to address solvency issues within a financial conglomerate such as double or multiple gearing, risks incurred by unregulated entities, and erection of firewalls between subsidiaries and between subsidiaries and parent companies.⁵² In addition, due to restriction for foreign banks access before, there were no regulations on foreign financial institutions, which may result in unexpected outcome.

4.2.2. Chinese Legislation Responses

Realizing the importance of regulations, China authority promptly promulgated a series of banking regulations before or shortly after China's entry to the WTO in response. This round of legislation focused mainly on foreign banking transactions which were absent before. A non-exhaustive list of new regulations on administering banks especially foreign bank is presented

⁵⁰ Special Studies opening markets in Financial Services and the Role of the GATS, World Trade Organization, embargo Until 0001 GMT 22 September 1997

⁵¹ Special Studies opening markets in Financial Services and the Role of the GATS, World Trade Organization, embargo Until 0001 GMT 22 September 1997

⁵² Tang (2002), ADB; Yun-Hwan Kim, Financial Opening Under the WTO Agreement In Selected Asian Countries: Progress and Issues, ERD Working Paper Series No. 24, ADB, 2002

as follows:

- *The Regulations of the People's Republic of China on the Administration of Foreign Funded Financial Institutions (The Regulations)* promulgated in December 20, 2001, and effective in February 1 2002;
- *Detailed Rules for the Implementation of the Regulations of the People's Republic of China on the administration of Foreign-funded Financial Institutions (The Rules)* promulgated in January 29, 2002, effective in February 1, 2002;
- *Public Notice of the People's Bank of China on Relevant Issues Concerning the Market Entry of Foreign-funded Financial Institutions* was promulgated in September 12, 2001, effective in November 12, 2001.
- *People's Republic of China Foreign Exchange Control Regulations (Revised)*, promulgated in January 29 1996, effective in April 1 2002;
- *Draft PBOC [2002] Temporary Administrative Regulations on RMB Inter-bank Borrowing*;

A new round and deeper banking reform is to be initiated in late 2003. Different from the first round of new legislations mainly for foreign banks, the expected reform now focuses on strengthening the central financial supervision on banking in general. Related legislations are under careful consideration, which includes amendments to the Central Bank Law and the Commercial Bank Law, Banking Supervision and Management. In addition, the regulatory functions of the Central Bank have been unbundled with the creation of a new institution—China Banking Regulatory Commission. The reform represents a major change from direct government intervention to macro indirect supervision within a sound legal framework on banking.

4.2.3. Implication on Foreign Banks

New regulations, together with Chinese WTO banking commitments, have significant impact on foreign institutions on local currency lending. Through these regulations, Chinese authorities effectively control the expansion of local currency lending by foreign banks, therefore, the potential turmoil from over competition will be contained.

i. Capitalization Requirement

While China gradually removes the geographic restriction for foreign banks, new regulations were set out with respect to market access. Most relevant rule is a relatively high capitalization requirement.⁵³ The capitalization requirement is the premise for a foreign bank to do RMB business for no less than three years and made profits for the two successive years.⁵⁴ It processes in a tiered basis. Each tier has a minimum capitalization requirement and specific scope of business and access to customers - the higher the tier, the larger the allowable scope to access so does the capitalization requirement.⁵⁵ According to the new regulation, the minimum level of capitalization permitting basic RMB business for branches is a working capital of no less than 200,000,000 RMB equivalent (about US\$ 24 million), for foreign banks it is no less than

⁵³ The Rules, article 20.

⁵⁴ The Regulations, promulgated Dec. 20, 2001, effective Feb. 1, 2002, article 20; the Rules, article 38

⁵⁵ Allens Arthur Robison, Banking on China, Issues Facing Overseas Banks in China, 31 March 2003.

400,000,000 RMB equivalent (about US\$ 48 million).⁵⁶ With this requirement, only limited foreign banks may operate and deal with an expanded range of businesses and customers.

ii. Requirement on RMB Deposit Base

To engage in RMB business the foreign bank must have practiced in the city it wishes to do RMB business in for no less than three years and have made profits for the two successive years⁵⁷. Moreover, foreign banks have a minimum threshold when it comes to building an RMB deposit base. Factors regulating foreign banks in this regard include:

- (a) The high level of capitalization required for each bank or branch.⁵⁸
- (b) A “one branch per year rule”⁵⁹ and geographical restrictions on RMB business which inhibit foreign banks’ ability to expand customer bases and compete with domestic banks in traditional trade.
- (c) Restriction of customer types on access to the domestic market. Scaled capitalization and the way it relates to customer type, effectively restrict foreign banks doing local currency business with FOEs and overseas customers. This is because at the higher end of capitalization, where the customer type expands to include domestic clients, it is difficult for capitalization costs to justify returns. FOEs and foreign citizens are a relatively small group in China with limited RMB deposits, and therefore do not satisfy foreign banks’ RMB deposit needs.⁶⁰

iii. Requirement on Interbank Borrowing

According to Article 5 of the Regulations of the People’s Republic of China on the Administration of Foreign Funded Financial Institutions, foreign banks shall rely on interbank RMB loans to fund their own RMB lending business when building an RMB deposit base. Practically speaking, the margins for overseas banks may be lowered by the narrow difference between interbank borrowings and the regulated interest earnings on customer loans.⁶¹

Because of foreign banks’ reliance on interbank loans, any regulation on access to this source would strain their capacity to do RMB business. A *Draft Administrative Regulations on RMB Inter-bank Borrowing*, initially mooted to commence by the end of 2006 but possibly earlier, states that a bank’s total RMB interbank borrowings cannot exceed 40% of its total RMB liabilities.⁶² This draft regulation would apply to both domestic and overseas banks. However, since domestic banks have already subject to the 40% threshold, this regulation largely influences

⁵⁶ The Regulations of the People’s Republic of China on the Administration of Foreign Funded Financial Institutions, promulgated Dec 20, 2001, effective Feb 1 2002, Article 5

⁵⁷ The Regulations of the People’s Republic of China on the Administration of Foreign Funded Financial Institutions (the Regulations), promulgated Dec 20, 2001, effective Feb 1, 2002, article 20; Detailed Rules for the Implementation of the Regulations of the PRC on the administration of Foreign-funded Financial Institutions (the Rules), article 38

⁵⁸ The Regulations of the People’s Republic of China on the Administration of Foreign Funded Financial Institutions, promulgated Dec 20, 2001, effective Feb 1 2002, Article 5

⁵⁹ The Detailed Rules for the Implementation of the Regulations of the People’s Republic of China on the Administration of Foreign-funded Financial Institutions, promulgated Jan 29, 2002, effective Feb 1, 2002, Article 14.

⁶⁰ Allens Arthur Robinson, *Banking on China: Issues Facing Overseas Banks in China*, 2003

⁶¹ Article 5 of the Regulations of the People’s Republic of China on the Administration of Foreign Funded Financial Institutions, promulgated 20/12/01, effective 01/02/02

⁶² Draft PBOC [2002] #28

foreign banks. In practice, foreign banks with RMB lending business may be strained because a significant portion of their RMB liabilities would normally be RMB deposit. However, as discussed above, foreign banks have constraints in expanding the RMB deposit base.

4.2.4. Legal Evaluation

Some commentators have described China as perverting its WTO commitments to give overseas banks equal market access by setting a series of regulations which have *de facto* unfavorable impact on foreign banks. The question is if Chinese legislations and regulations are WTO-consistent. To answer this question, two-step examinations are necessary in accordance with GATS rule analysis described earlier in this Section. The first step is to examine if China complies with GATS general and specific obligation, which is MFN and NT. The second is to examine if there are exceptional provisions on banking.

First, since there are no regulations related to the country of origin of service supplier, there is no base for declaring MFN inconsistency. Regarding NT, as stated earlier, China inscribes “None” to nearly all of the “Banking and Other Financial Services” in its Schedule on National Treatment, according to Financial Services Annex. It implies that China shall not, both *de jure* and *de facto*, offers preferential treatment to domestic banking through *any measure* affecting the supply of banking services. While some Chinese regulations affect foreign banks exclusively, for instance, the high capitalization requirement for foreign banks, one may argue that it could be subject to the NT violation complaint. However, rather than intending for discrimination, those regulations aim at excluding relatively small banking-service-providers out of the Chinese market. Small and middle foreign banks’ capitals are more mobile than big banks’, which are harmful for country’s financial stability. Based on this analysis, this author tends to interpret it as effective regulation for healthy competition environment rather than *de facto* discrimination. Zhuhai, a special economic zone, which was required to open its market three years after China’s accession according to its GATS schedule, was actually made accessible for entry two years earlier by Chinese authorities.

For the second-step test, while GATS set out the general rules on all service sectors, Financial Services Annex, specifically for financial sector, give the flexibility for Member through prudential principle. Even though there are some regulations that may have unfavorable impact, Chinese regulations are prudential in nature which fall into the coverage of GATS Annex. Therefore, this author concludes that those regulations on banking are “prudential principle” which are consistent with GATS agreement and Financial Services Annex.

These new regulations show that Chinese authorities actually are aiming at two goals simultaneously: putting pressure on SCBs for further reforms by exposing them to foreign competitor on the one hand; and establishing a safeguard valve through regulatory control, on the other hand. Obviously, such supervision is essential for Chinese domestic banking system reform to avoid unexpected financial turmoil. This complementary approach may be instructive for other WTO developing Members with weak financial system to make and conduct its banking commitment.

VI. CONCLUSION

There is no doubt China's WTO service commitment represents the most rigorous liberalization in the WTO history. Rather than simply arguing that China yields to external pressure by making unfounded and risky commitment, this paper explores the endogenous Chinese reform logic. It is a striking phenomenon that Chinese private sector shows its strong economic performance though under unfavorable conditions compared to both SOEs and FOEs in the same playing field. By applying the reform theory, it suggests that private sector would be the major potential source to drag increasing marginal benefits to contribute Chinese banking reform sustainable, if being granted no less favorably endowment as other players enjoyed, followed by FOEs.

Since Chinese domestic barriers are clearly identified, this study further addresses the issue why China has chosen to tackle the inefficiency problem indirectly through WTO accession rather than remove them directly. Formalizing the commitments in WTO would lock-in Chinese liberalization on track as resistance inevitably arises from China's affected industry sectors. To avoid the potential turmoil from *de facto* privatization is the primary political consideration. From an economic perspective, China benefits from banking liberalization in a number of ways.

Though China economic reform logic illustrates the parallel direction for banking reform with WTO requirement, one may wonder from a legally perspective, if GATS request more obligation than China's willing to concede and how China should react. Two conclusions are drawn in these regards: first, there is sufficient flexibility to regulate domestic financing regulations under the GATS; second, the new legislation China promulgates has provided effective valve for potential over competition from foreign banks access. There are two roles Chinese authority plays simultaneously: putting reform pressure on SCBs by exposing them to foreign competitor on the one hand; and establishing a safeguard valve through regulatory control, on the other hand. This complementary approach helps China to avoid unexpected financial turmoil. In terms of the role of WTO commitment, China creatively applies the National Treatment provisions in a Chinese way to tackle its domestic barriers on private sector.

China's policy consideration in making WTO commitment provides an interesting case of combining the active role of GATS with the dynamics of domestic economic reform. This case illustrates that sound domestic economic policy with a clear vision is crucial in order to take full advantage of the WTO commitment vis-a-vis the rest of world.

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Table 1: Coverage of Specific Commitments (percent)

| | High-income Countries ⁹ | Low- and middle-income countries ¹⁰ | Large developing nations ¹¹ | China |
|---|---------------------------------------|--|--|-------|
| <i>Market access</i> | | | | |
| Unweighted average count (sectors-modes listed as a share of maximum possible) | 47.3 | 16.2 | 38.6 | 57.4 |
| Average coverage (sectors-modes listed as a share of maximum possible, weighted by openness or binding factors) | 35.9 | 10.3 | 22.9 | 38.1 |
| Coverage/count (average coverage as a share of the average count) | 75.9 | 63.6 | 59.3 | 66.4 |
| No restrictions as a share of total offer (unweighted count) | 57.3 | 45.5 | 38.7 | 40.2 |
| No restrictions as a share of maximum possible | 27.1 | 7.3 | 14.9 | 23.1 |
| <i>National treatment</i> | | | | |
| Unweighted average count (sectors-modes listed as a share of maximum possible) | 47.3 | 16.2 | 38.8 | 57.4 |
| Average coverage (sectors-modes listed as a share of maximum possible, weighed by openness or binding factors) | 37.2 | 11.2 | 25.5 | 45.0 |
| Coverage/count (average coverage as a share of average count) | 78.6 | 69.1 | 66.1 | 78.4 |
| No restrictions as a share of total offer (unweighted count) | 65.1 | 58.0 | 52.3 | 63.5 |
| No restrictions as a share of maximum possible | 30.8 | 9.4 | 20.2 | 36.5 |
| | 24.8 | 6.9 | 14.3 | 29.8 |
| <i>Memo item</i> | | | | |
| No restrictions on market access and national treatment as a share of maximum possible | 293.0 | 100.0 | 239.0 | 356.0 |
| Number of sectors committed | | | | |

Source: Ianchovichina et al (2001).

Note: The breadth and depth of commitments by other countries are understated because their more recent commitments in telecommunications and financial services have not been taken fully into account.

Table 2: China's WTO Commitments Relating to Banking Services

| General WTO services sector | Description of commitment and key limitation | Time frame |
|------------------------------------|---|---|
| Horizontal (all services sectors) | <ul style="list-style-type: none"> • Minimum foreign investment in equity joint ventures shall be no less than 25 percent of the registered capital of the joint venture. • Conditions of ownership, operation, and scope of activities for existing foreign service suppliers will not be made more restrictive than they exist as of the date of China's accession. | <ul style="list-style-type: none"> • Upon accession • Upon accession |
| Financial (banking services) | <ul style="list-style-type: none"> • Foreign providers of foreign currency services permitted without geographic and client limitations. • Foreign providers of local (Chinese) currency services permitted without geographic and client limitations. • Foreign providers of banking services subject to licensing and qualification requirements. | <ul style="list-style-type: none"> • Upon accession • Within 5 years of accession • Upon accession |

Source: China WTO Protocol, 2001, WTO

Table 3: China's Financial Commitments on Market Access: Past, Present and Future

| Sector | 1994 | 1999 | 2001 | 2008 |
|--------------------|--|--|--|--|
| FINANCIAL SERVICES | | | | |
| Banking | Mode 1: unbound Mode 2: unbound Mode 3: through a branch, subsidiary JV only in specified regions, subject to minimum asset and local presence (as rep. office) requirements; acceptance of deposits only from non-residents in foreign currencies (with some exceptions), and no loans to Chinese citizens. | Mode 1: unbound except for provision of data, advice, etc. Mode 2: none. Mode 3: geographic limitation: none for foreign currency business, but local currency only in 4 cities. Inter-regional supply of services permitted. Clients: only foreign currency business. Licenses: only prudential criteria. | Mode 1: unbound except for provision of data, advice, etc. Mode 2: none. Mode 3: geographic limitation: none for foreign currency business, but local currency only in 4 cities. Inter-regional supply of services permitted. Clients: only foreign currency business. Licenses: only prudential criteria. | FULLY LIBERALIZED BY 2006. Mode 3: Geographic limitations phased out gradually by 2006. Clients: local currency business with Chinese enterprises by 2003 and all clients by 2006. |

Source:

WTO (1994), "China-Schedule of Specific Commitments," GATS/SC/19.

WTO (2002), "China-Schedule of Specific Commitments," GATS/SC/135

Sino-US bilateral Agreement on Chinese WTO accession in 1999

Table 4: Performance of China's State-owned Commercial Banks, 1996

| | Capital replenishment rate | Profit-net assets rate | Loan circulation rate |
|--------------------------------|----------------------------|------------------------|-----------------------|
| State commercial banks | 4.37 | 5.55 | 1.07 |
| Industrial and Commercial Bank | 4.35 | 6.17 | 1.3 |
| Agricultural Bank | 3.49 | 1.44 | 1.3 |
| Bank of China | 4.84 | 10.29 | 1.01 |
| Construction Bank | 4.81 | 5.7 | 0.68 |

Source: Data compiled from PBOC, Almanac of Finance and Banking in China, various years; Li Xinxin, 1998. 'Looking at China's potential financial risks from the East Asian financial crisis: Analyses of the assets operation of the SCBs, reform, 3(March): 31-9 and 86; RGCFSR, 1997. "A tracking study of the Chinese financial system reform'. Reform, 3: 64-75, and 4: 83-98

Table 5: Shares of State and Non-public Sectors (%)

| | | State Sector | | Non-public Sector | |
|-------------|-------------------------|--------------------------|------------------|-------------------------|------------------|
| | | Fixed Capital Investment | Urban Employment | Gross Industrial Output | Urban Employment |
| | Gross industrial output | | | | |
| 1978 | 77.6 | | 78.3 | | 0.2 |
| 1980 | 76 | 81.9 | 76.2 | 0.5 | 0.8 |
| 1985 | 64.9 | 66.1 | 70.2 | 3.1 | 3.9 |
| 1990 | 54.6 | 66.1 | 62.3 | 9.8 | 5.7 |
| 1995 | 34 | 54.4 | 59 | 29.4 | 24.5 |
| 1996 | 28.5 | 52.5 | 56.7 | 32.1 | 28 |
| 1998 | 28.2 | 54.1 | 43.8 | 40 | 46.7 |

Source: China Statistical Yearbook, various editions

Note: Non-public sector means all sectors other than state and collective ones.

Table 6: China: State Bank Credit Allocation, 1993-2000 (In percent of GDP)

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|--|------|------|------|------|-------|-------|-------|------|
| Claims on nongovernmental sector of which: | 97.5 | 89.5 | 88.3 | 94 | 102.9 | 112.2 | 121.8 | 125 |
| Claims on non-SOE sector | 35.7 | 32.6 | 31.8 | 35.4 | 37.4 | 41.2 | 48.8 | 57 |
| Claims on SOE sector | 61.8 | 56.9 | 56.5 | 58.6 | 65.5 | 71 | 73 | 67.6 |

Sources: IFS; PBC; and IMF staff estimates

Table 7: Comparison of Capital Account Liberalization and Financial Service Liberalization

| | Domestic Funds (I) | International Funds (II) |
|---|--|--|
| Credit provided by domestic supplier (A) | Neither financial service trade nor international capital flow | Capital account liberalization |
| Credit provided by foreign supplier abroad (B) | Financial service liberalization | Capital account liberalization and financial services liberalization |

Table 8: Members with MFN Exemptions (by sector)

| Sectors | Countries |
|---------------------------|---|
| Financial services | Brunei Darussalam, Canada, Colombia, Cote Divoire, El Salvador, European Union and its Member States, Honduras, Hungary, Indonesia, Israel, Liechtenstein, Mauritius, Nicaragua, Pakistan, Peru, Philippines, Senegal, Singapore, Slovak Republic, South Africa, Swaziland, Switzerland, Turkey, United Arab Emirates, United States, Venezuela |

Source: Aaditya Mattoo, MFN and The GATS, 1999