WORLD FINANCIAL SERVICES LIBERALIZATION

AND

THE OPENING-UP OF CHINA'S FINANCIAL MARKET

By

LI, An

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
for the degree of

MASTER OF PUBLIC POLICY

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ABSTRACT

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A modern, well-functioning financial system is an essential part of a market economy. The current world trading system is placing increasingly importance on financial services trade. Great efforts have been taken to make the financial services trade better functioning and become more rule-based. The General Agreement on Trade in Services (GATS) and the Financial Services Agreement are one of the central achievements in this area.

After more than twenty years of reform and opening-up, China's financial services market has become an integral part of the world financial services market. Because of its high economic growth rate and the huge market potential, China's financial services market is also growing very fast in recent years. China's commitments upon its accession to the WTO in 2001 mean that a much freer and more open market will occur in China within five years.

This thesis focuses on the following two aspects: first, explain some major concepts, principles and framework of GATS, review the formation of FSA in the context of GATS, explain the benefits from liberalization of financial services trade. Second, review the reform and opening-up process in China's financial services sector, analyze the implications for China's financial services trade liberalization under its WTO obligations, assess the current situation of China's financial industry and the foreign financial institutions' performance in China, and provide some inputs for China's future financial services trade liberalization.

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I. Introduction

The establishment of the multilateral trading system over the past 50 years can be regarded as one of the most remarkable achievements of international cooperation in history. The liberalization of trade in goods, which has been promoted through negotiations in the GATT in the second half of the 20th century, has been one of the greatest contributors to the world economic growth and social development.

Meanwhile, we are aware that producers and exporters of any tangible goods will not be competitive without access to efficient finance, telecoms and transport systems. No one could find such an example in the current world: a prosperous country with an inefficient and expensive services infrastructure. So it is not surprised that over the recent two decades trade in services has grown even faster than merchandise trade. The services sector has become the largest and fastest-growing sector of the world economy, providing more than 60% of global output and in many countries an even larger share of employment.[1] The General Agreement on Trade in Services (GATS), which entered into force in January 1995, is so far the first and only set of multilateral rules covering international trade in services, and also one of the central achievements of the Uruguay Round.

Over the last two decades, the world financial services have experienced great

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[1] See WTO Secretariat Paper, *GATS—Fact and Fiction*, p. 4.

development as the consequence of financial deregulation and significant progress on information and telecommunication technology. Financial services are backbone of modern economies. Efficient financial services sector is an important contributor to economic growth and stability. As the largest service sector, financial services, which include three major segments—banking, insurance and securities services, were placed great importance in the Uruguay Round trade negotiations, and also one of the most complicated and difficult issues. After failing to conclude at the end of the Uruguay Round, and after reaching an interim agreement in July 1995, the World Trade Organization (WTO) Financial Services Agreement (FSA) was finally concluded in December 1997. 102 WTO members' market-opening commitments were included in that agreement. Thus, financial services were fully subject to multilateral trade rules.

The FSA is a milestone for the WTO because a significant number of WTO members agreed to a legal framework for cross-border trade and market access in financial services and to a mechanism for dispute settlement. It extends the GATS to financial services. However, the progresses achieved so far are far from complacency. For the most part, the FSA simply formalizes the status quo, more efforts need to be taken for further market liberalization.

Since 1978, China has adopted the opening-up policy and begun its economic reforms, changing from a closed central planning economic system towards an opening

market economy. China’s opening-up in financial sector started in the same period. In 1979, the first foreign bank representative office was established in Beijing, China. Two decades since then, significant changes have taken place in China’s financial sector. China’s entry into the WTO in December 2001 signals the further determination and commitments to financial reform and opening-up.

With China’s gradual opening-up and rapid economic growth, foreign financial institutions are facing great opportunities in China and expanding rapidly. By the end of October 2003, there are total 182 foreign bank branches, 209 foreign bank representative offices and a number of other financial institutions operating in China. Meanwhile, China also benefits from the financial reform and opening-up. The foreign financial institutions have played an active and positive role in China’s financial sector. They have introduced into China the modern financial operating system and advanced management, pushed Chinese financial institutions to improve their service standard and quality, accelerated China’s financial reform process and strengthened China’s financial system. Of course, no need to reticence, some persistent problems still exist in China’s financial sector; Chinese financial institutions are confronted with more intense competition from the foreign competitors. According to China’s commitments upon the accession to the WTO in 2001, financial sector will be fully open to foreigners in 5 years. The only way to survive is to make self stronger and win the challenges.

This thesis will focus on the following two aspects: first, explain some major concepts, principles and framework of GATS, review the formation of FSA in the context of GATS, explain the benefits from liberalization of financial services trade. Second, review the reform and opening-up process in China's financial services sector, analyze the implications for China's financial services trade liberalization under its WTO obligations, assess the current situation of China's financial industry and the foreign financial institutions' performance in China, and provide some inputs for China's future financial services liberalization.

II. Economic Analysis of Financial Services Liberalization

1. The Growing Importance of Financial Services Trade

Financial services sector is a large and growing sector is both developed and developing countries. The growth of this sector is particularly high in those economies that are experiencing rapid modernization. Trade in financial services is also increasing at a fast pace, as the result of the use of new financial instruments and technological change, as well as financial deregulation and trade liberalization. However, the financial services sector is far more important than its numerical share in the economy implies. Financial services are the backbone of modern economies. It is difficult to think of any economic activity in a modern society that does not depend either directly or indirectly upon services

provided by the financial sector.

Measurement of production and trade in financial services is much more complex than in other service sectors, this causes the problem of data deficiency. However, the data that are currently available still can give us the perception of the importance of the financial services sector. Tables 1 and 2 depict the share of financial services in total employment and GDP in some countries. Employment in the financial services sector in these countries ranges from about 3 percent to 5 percent. Moreover, from 1970 to 1995 the employment in this sector is growing in many countries listed in Table 1. As showing in Table 2, value-added in the financial services sector as a share of GDP has also grown considerably over the 1970-1995 period. By the mid-1990s, the United States and Switzerland had value-added shares of 6.6 and 13.3 percent respectively, the highest among industrialized countries. For developing countries, financial services are the most important in Singapore (12 percent) and Hong Kong, China (9.4 percent).

The important role of the financial services sector in national economies can also be seen from two other indicators. Chart 1 shows the size of the banking sector in some industrialized, developing and transition countries. Total banking assets in Japan, EU and the US amounted to about US$10 trillion each in 1994, and together they accounted for three quarters of global banking assets. Banking assets typically far exceed GDP in these countries. The size of financial markets in developing economies was mostly between

US$10 and US$100 in 1994, and some of them are between US$100 billion and US$ 1 trillion. By contrast, countries with the smallest banking sectors and banking assets of less than US$1 billion are also amongst the least well-off in the world. In those countries, banking assets are typically much smaller than GDP. Chart 2 shows the importance of the insurance sector in industrialized countries. Total insurance premiums averaged 8 percent of GDP for OECD countries during 1987-1994.

The growth of international financial activities has been even more rapid than the growth of domestic markets. The financial services markets have increasingly become globally. Competition among different types of financial institutions has become intense. Worldwide cross-border mergers and acquisitions (M&As) in banking and insurance are now reshaping the industry. Such M&As are aimed at the global restructuring and strategic positioning of firms in these industries. Furthermore, although many of the activities in international financial markets center on industrial countries, developing and transition economies have become increasingly important players. In the first half of the 1990s, Latin America, East Asia, and Central and Eastern Europe increased their recourse to international capital markets considerably. The growing accessing to international capital markets as a means of financing in developing and transition economies suggests that companies and markets have become more open and more sophisticated.

2. The Driving Forces of Financial Services Growth

Financial services sector has experienced rapid growth in recent years. This rapid growth is mainly driven by two factors: technological innovations and financial deregulation.

First, technological innovations have a major impact on the financial services sector. Revolutionary changes have taken place in this sector in the past years, such as the advent of electronic data processing and transmission, improved computer technology, automatic teller machines, and telebanking. Furthermore, a new era of Internet-based banking services has arrived. The Internet will have a profound effect on the financial services industry. The Internet cuts transaction costs, provides new channels for commercial transactions and lowers barriers to entry for smaller, geographically remote competitors. The global reach of the Internet means that banking, insurance and brokerage services can be purchased from anywhere in the world. By and large, the technological innovations have added a new dimension to the workings of the financial services sector. They offer new opportunities for enhanced efficiency and stimulate the rapid growth in this sector.

Second, the trend of deregulation in financial sector all over the world has affected dramatically the financial institutions' behavior. In recent years, major changes were made in OECD countries in the financial services regulatory regimes towards

market-based decision-making, e.g., the removal of interest-rate controls and the liberalization of portfolio allocation rules. Meanwhile, deregulation of various restrictions on the activities of the suppliers of financial services, which involves both prudential and non-prudential regulation, has been followed or accompanied by re-regulation in terms of stronger prudential and transparency rules as well as competition policy[2]. All these policy measures are crucial for the healthy and sustainable growth in financial services area.

3. Benefits from Financial Services Liberalization

It is by now well accepted that the multilateral trading system has played a key role in increasing income and growth via trade liberalization. Numerous studies had shown convincingly the significant benefits from trade liberalization in the area of trade in goods, and the same case in the area of services trade. These benefits are realized through the specialization on the basis of comparative advantage, dissemination of know-how and new technologies, and realization of economies of scale and scope. From an economic perspective, financial services trade is no different from trade in goods or other services. Liberalization of financial services trade can also have the same strong positive effects.

Trade liberalization can make the financial services sector more efficient and stable. Financial institutions can take advantage of economies of scale and specialize according to their comparative advantage. On the other hand, financial institutions can

[2] See "*Guide to the GATS*", WTO Secretariat (2000)

also broaden their spectrum of services to take advantage of economies of scope. Liberalization intensifies competition among financial institutions, which forces them to reduce cost, enhance management, increase efficiency, and improve the quality of their services. International trade, largely through the commercial presence of foreign financial institutions, can create significant benefits from the transfer of knowledge and technology. Liberalization of financial services can also reduce the systemic risk for small financial markets which are less able to resist large shock.

Liberalization of financial services trade promotes better macroeconomic policies and government regulation. Direct monetary policy instruments are likely to be replaced by indirect instruments that are less distorted and helpful to develop financial markets. Liberalization also puts pressure upon governments to pursue prudent monetary, fiscal and exchange rate policies. Liberalization can also reduce or eliminate other kinds of distorted domestic regulations or direct financial market interventions.

Liberalization may improve inter-temporal and inter-national resource allocation. Open and more efficient financial markets can increase the returns to investments. This stimulates aggregate savings and higher investments which in turn boost growth. Liberalization of international trade in financial services facilitates the flow of capital from countries with capital surpluses to those with shortages. Countries with high savings rates and relatively low returns on investments can export capital and raise their returns.

The benefits of financial services liberalization can also be observed from another aspect, i.e., trade protection is not the best approach to address certain concerns relating to trade liberalization. One concern is that foreign financial institutions will dominate the domestic market after liberalization and will abuse this position. However, there is no reason to assume that foreign suppliers will always be more efficient than domestic ones; their presence will in fact promote the efficiency of the domestic sector. Alternatively, if a government wishes to maintain a certain national presence or wishes to provide temporary support to national suppliers, a more economically efficient means is to use fiscal incentives rather than restrictions on trade. As for the question of the abuse of market dominance, competition among the incumbent suppliers combined with the openness of the market for new entrants should minimize the danger of abuse. If this is not sufficient, governments could deploy competition policies to help secure competition.

Another concern relates to the potential for selective servicing by foreigner suppliers, which might only service profitable market segments and result in underprovision of certain services, then could have detrimental effects on domestic economy. However, in this situation, other alternative measures, such as fiscal incentives, would be more appropriate than keeping financial markets closed. It is also possible to impose certain requirements, such as universal service obligations, on foreign and domestic financial institutions to ensure that social objectives are met without sacrificing

the efficiency benefits of competition. One other concern is that the existence of too many financial institutions because of the entry of more foreign firms. This concern can be best addressed through prudential measures and measures to facilitate orderly exit from market, or permission of an orderly consolidation in the financial system rather than protectionism.

III. GATS and Financial Services Agreement

1. History of GATS

The pre-Uruguay Round GATT framework applies only to trade in goods, it was largely due to the insistence of the United States that trade in services was placed on the Uruguay Round agenda[3]. The major motivation for the US's initiative was that the US was losing global markets and part of its domestic market in many basic manufacturing sectors because of the competition from the newly industrializing countries (NICs), and at the same time US still remained or even strengthened its high competitive advantage in service sectors, especially in financial services and telecommunications sectors that are highly knowledge and technology intensive. Based on the same logic, some developing countries were of the view that liberalized trade in services would result in their domestic providers being out-competed by American firms. Moreover, most developing countries could see little benefit accruing to them through access to the services markets of other

[3] See Michael J. Trebilcock & Robert Howse, *The regulation of International Trade*, (2nd edition, 1999), p. 278.

countries. However, on the basis of a number of carefully negotiated compromises, the hard negotiations reached a historical agreement, which was one of the central achievements of the Uruguay Round, even though negotiations in some sectors needed to continue. As an integral part of the WTO, the GATS was signed in Marrakesh on 15 April 1994 by more than 100 countries and entered into force in January 1995.

2. Framework and Main Elements of GATS

The GATS is the first and only multilateral and legally enforceable agreement governing rules on international trade in services. It contains the general obligations that all members have to apply. The Council for Trade in Services under the WTO General Council oversees the operation of the agreement. Like the agreements on goods, GATS operates on three levels: the main text containing general principles and obligations; annexes dealing with rules for specific sectors; and individual countries' specific commitments to provide access to their markets. Unlike in goods, GATS has a fourth special element: lists showing where countries are temporarily not applying the "most-favored-nation" principle of non-discrimination. These commitments—like tariff schedules under GATT—are an integral part of the agreement.

(1). Definition and Coverage of Services

The 29 articles in the GATS covers all internationally-traded services with two exceptions: services provided to the public in the exercise of governmental authority, and,

in the air transport sector, traffic rights and all services directly related to the exercise of traffic rights.

The definitions in Article I.2 of the GATS evoke a very broad view of the meaning of trade in services, without attempting to define services themselves. According to that definition, international services are divided into the following four modes:

(Mode 1) Cross-border supply: Services flows from the territory of one Member into the territory of another Member, e.g. international telephone calls.

(Mode 2) Consumption abroad: A service consumer or his/her property moves into another Member's territory to obtain a service, e.g. tourism.

(Mode 3) Commercial presence: A service supplier of one Member establishes a territorial presence, including through ownership or lease of premises, in another Member's territory to provide a service, e.g. foreign banks setting up operations in a country.

(Mode 4) Presence of natural persons: Persons of one Member enter the territory of another Member to supply a service, e.g. accountants, doctors or teachers.

Article I: 3 sets out the entities to which GATS obligations on services will apply. This includes not only three levels of governments (central, regional and local) but also "non-governmental bodies in the exercise of powers delegated" by these three levels of government. Members remain responsible for the compliance of these non-governmental

entities with GATS provisions. This represents an important departure from typical GATT practice of only seeking to bind governmental entities.

(2). General Obligations and Disciplines

General obligations and disciplines are applicable immediately to all members in all services sectors. The main general obligations and disciplines are the MFN obligation (Article II), transparency (Article III), and a commitment to further liberalization negotiations (Articles XIX to XXI).

MFN means treating one's trading partners equally. Under GATS, if a country allows foreign competition in a sector, equal opportunities in that sector should be given to service providers from all other WTO members. MFN applies to all services, but under some circumstances Members can be exempted from the MFN obligation. Article II:2 allows a Member to maintain exemptions to MFN treatment, provided that the Member lists the exempted measures in the Annex on Article II Exemptions, and provided that the conditions listed in that Annex are complied with. The conditions include: that exemptions granted for more than five years shall be reviewed by the Council for Trade in Services to determine "whether the conditions which created the need for the exemptions still prevail" (Annex: Articles 3, 4(a)); that exemptions should not last for more than ten years and must be subject to negotiation in subsequent rounds of multilateral negotiations.

National treatment is treated differently for services. For goods (GATT) and

intellectual property (TRIPS) it is a general principle. In GATS it only applies where a country has made a specific commitment, and exemptions are allowed.

According to the transparency requirements in GATS, all Members must publish all relevant laws and regulations. Inquiry points were set up in Members' relevant governmental agencies. Foreign companies and governments can use these inquiry points to obtain information about regulations in any service sector. Each Member has to notify the WTO of any changes in regulations that apply to the services that come under specific commitments.

The commitment to participate in future negotiations for progressive liberalization is sometimes referred to as the "build-in agenda" for future negotiations. Article XIX commits Members to enter into "successive rounds of negotiations…with a view to achieving a progressively higher level of liberalization". Liberalization is to occur "on a mutually advantageous basis" and should secure "an overall balance of rights and obligations". It is made explicit that what is involved is not merely the discipline of measures that discriminate against foreign suppliers directly or intentionally, but more generally "the reduction or elimination" of measures which have "adverse effects on trade in services".

(3). Commitment-Specific Obligations

With regard to the commitment-specific obligations, Members are bound only in

those sectors for which they have provided schedules and only to the extent of the commitments undertaken in those schedules. Like bound tariff, "bound" herein means that those commitments made by Members can only be modified or withdrawn after negotiations with affected countries—which would probably lead to compensation. Specific commitments are scheduled based upon a classification of activities developed by the GATT Secretariat and based on the United Nations Central Product Classification.

The commitment-specific GATS obligations are contained in the schedules of commitments notified by the Members individually. These schedules include, for each Member, a "positive" list of sectors in which the member is willing to make commitments and a "negative" list of derogations from the broad principles of market access and national treatment described in Articles XVI and XVII. In sectors not scheduled, Members make no commitment to liberalize beyond the general obligations —i.e., MFN, transparency, and the commitment to engage in future negotiations. In scheduled sectors, broad obligations of market access and national treatment apply, except where Members have formulated reserves individually.

3. Negotiations of Financial Services Agreement

Financial services sector was one of the four areas in services trade negotiations that could not complete the negotiations by the December 1993 deadline for the Uruguay Round. In order to avoid stopping of the whole Uruguay Round process, the parties agreed

to extend the negotiations in those four areas—maritime services, basic telecommunications services, movements of natural persons, and financial services. The deadline for financial services negotiations was extended to 1 July 1995. However, the parties failed again to conclude the negotiations by the new deadline; instead, an interim agreement was signed to consolidate existing offers for a given period (up to 1 November 1997). After that period, offers could be withdrawn, maintained or improved during 60 days. The July 1995 interim agreement set 31 December 1997 as the new deadline for a final agreement; this was advanced to 12 December when the negotiations resumed in the spring of 1997. Finally, The WTO's negotiations on financial services concluded successfully on 12 December after 70 WTO Members[4] reached a multilateral agreement to open their financial services sectors. It added the Fifth Protocol to the GATS (A total of 56 schedules of commitments representing 70 WTO Member governments and 16 lists of MFN exemptions (or amendments thereof) were annexed to this Protocol). The Protocol was open for ratification and acceptance by Members until 29 January 1999. 52 Member governments accepted the Protocol by the due date, and the Protocol was put into force on 1 March 1999. The Council for Trade in Services also decided that the Protocol would be

[4] The WTO Members concerned are: Australia; Bahrain; Bolivia; Brazil; Bulgaria; Canada; Chile; Colombia; Costa Rica; Cyprus; Czech Republic; the Dominican Republic; Ecuador; Egypt; El Salvador; the European Communities (15 Member States); Ghana; Honduras; Hong Kong, China; Hungary; Iceland; India; Indonesia; Israel; Jamaica; Japan; Kenya; Korea; Kuwait; Macau; Malaysia; Malta; Mauritius; Mexico; New Zealand; Nicaragua; Nigeria; Norway; Pakistan; Peru; Philippines; Poland; Romania; Senegal; Singapore; Slovak Republic; Slovenia; South Africa; Sri Lanka; Switzerland; Thailand; Tunisia; Turkey; the United States; Uruguay and Venezuela.

kept open for acceptance until 15 June 1999 for the remaining Members. For those Members accepting after 1 March, the Protocol would enter into force upon acceptance. This landmark agreement brings trade in financial services sector—worth trillions of dollars—under the WTO's multilateral rules on a permanent and full most-favored-nation basis. The agreement covers more than 95 per cent of trade in banking, insurance, securities and financial information.

Looking back to the post-Uruguay negotiating process of FSA, the main obstacle to the negotiations is that the industrial countries (especially the United States) were unsatisfied with the unwillingness of many developing countries (and even Japan) to commit to a substantial and binding opening of their domestic financial markets. These countries were willing to make few new commitments whereas most of the OECD countries' financial systems were already relatively open. This has raised the concern of industrial countries that some developing countries would free ride on an eventual MFN-based multilateral agreement, that is, they would be granted wider access to the industrial countries' financial markets while keeping their own markets relatively closed. This has made the industrial countries reluctant or unwilling to commit themselves to an MFN-based multilateral agreement on trade in financial services. The US's unwillingness to tolerate free riding was a major determinant of its strong position in negotiations. In the negotiations after the Uruguay Round, Japan achieved significant progress under strong

pressure from the United States. However, the United States still thought that the offers of the emerging markets largely unsatisfactory because the degree of market access implied by existing offers was insufficient and the coverage of existing commitments fell short of providing the critical mass needed to reach a meaningful multilateral agreement. Hence, deciding that no agreement was better than a bad agreement, US announced the withdrawal of most of its offer on financial services and the introduction of an MFN exemption on the whole sector. The European Union interpreted the situation from an optimistic aspect. It was of the view that the formal inclusion of financial services into a multilateral framework on the basis of a first agreement was itself worth pursuing, and the declaring failure might weaken the newly established WTO. With the cooperation of Japan, EU succeeded in securing the interim Protocol on Financial Services in July 1995[5].

The authors of "Financial Services Liberalization in the WTO" gave three possible explanations that led to the final conclusion of the negotiations in that book[6]:

First is the joint effort of US and EU governments. Unlike what happened during the Uruguay Round negotiations in other areas especially in agriculture sector, trade liberalization in financial services was not a transatlantic issue. In fact, the United States and Europe were trying hard to cooperate to provide joint leadership in the negotiations.

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[5] See Wendy Dobson & Pierre Jacquet, *Financial Services Liberalization in the WTO*, Institute for International Economics (1999), pp. 81-82.
[6] Ibid., pp. 83-85

US and EU's negotiating efforts toward third parties were better coordinated, at both the public and the private levels. In particular, the United States and the European Union made clear that developing countries would be denied any opportunity to postpone liberalization while watching a transatlantic conflict on this issue and waiting for its resolution. This signaled an encouraging willingness to achieve results through cooperation rather than unilateral action. The European Union's active diplomacy, seeking an agreement on the basis of substantially improved offers from different developing countries, also supported US demands and facilitated transatlantic cooperation.

Second is the joint effort of US and EU private sectors. Private firms in the United States and in the European Union have set up effective cooperation through the creation of the Financial Leaders Group (FLG) in 1996 between European and American financial service institutions. This effort promoted a dialogue conducive to more effective and balanced lobbying, and supported the pursuance for common positions and objectives. It also provided a useful framework for intermediating dissensions and differences of interests among firms of different sizes and from different countries. While the FLG noted that some developing countries' offers still were defective and inadequate, it insisted that offers on the table needed to be harvested through a permanent agreement. This position helped to mollify opposition in some circles, especially the US legislative to signing an agreement.

Last, an unexpected financial crisis motivated the on-going negotiations. In July 1997, the depreciation of the Thai bath detonated the Asian Financial Crisis. Countries in Southeast Asia were facing monetary and financial turmoil. This crisis in fact provided a fresh impetus to the slow-moving negotiating process. Although it might potentially provide these countries with further pretext of slowing down the liberalization process, the crisis was widely interpreted as signaling major problems within the financial systems of emerging market economies in Asia. The severity of the crisis and the dramatic reversal in market confidence toward Asia necessitated the countries in financial crisis to seek ways to restore stability and confidence. This situation helped to make IMF demands for financial reforms acceptable, and also highlighted the benefits, in terms of credibility, of binding some of the liberalizing measures in a multilateral agreement. To the extent that a multilateral agreement could help to restore credibility and contain the damage from this crisis, this may have also shifted the balance of judgments in industrial countries toward accepting an agreement that might otherwise have been tempted to find still insufficient.

These three possible factors suggest that by the end of 1997 most parties shared the perception that failure to reach an agreement would be very costly. Thus, after much uncertainty all along, the successful result was achieved finally.

4. Financial Services in the GATS

(1) Definitions of Financial Services

Financial Services are generally regarded as consisting of three major segments: insurance, banking and securities. The Annex on Financial Services provides a very broad definition on financial services. Paragraph 5(a) describes financial services as including "any service of a financial nature offered by a financial service supplier of a member"[7].

This definition is followed by a lengthy list of 16 financial services activities that fall within the definition. The list includes a comprehensive range of insurance services, traditional banking activities, as well as underwriting of securities and trading in virtually every existing form of security or negotiable instruments. In addition, consulting and brokering services connected with these transactions are included in financial services[8]. It

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[7] Paragraph 5(a) defines financial services as the follows: "A financial service is any service of a financial nature offered by a financial service supplier of a Member. Financial services include all insurance and insurance-related services, and all banking and other financial services (excluding insurance)."

[8] Paragraph 5(a) provides that the Financial services include the following activities:

Insurance and insurance-related services

(i) Direct insurance (including co-insurance):
   (A) life
   (B) non-life
(ii) Reinsurance and retrocession;
(iii) Insurance intermediation, such as brokerage and agency;
(iv) Services auxiliary to insurance, such as consultancy, actuarial, risk assessment and claim settlement services.

Banking and other financial services (excluding insurance)

(v) Acceptance of deposits and other repayable funds from the public;
(vi) Lending of all types, including consumer credit, mortgage credit, factoring and financing of commercial transaction;
(vii) Financial leasing;
(viii) All payment and money transmission services, including credit, charge and debit cards, travellers cheques and bankers drafts;
(ix) Guarantees and commitments;

seems that the clear intention of Paragraph 5(a) is to include as many activities as possible under the title of financial services.

Paragraph 5(b) excludes "public entity[9]" from the "financial service supplier" mentioned in Paragraph 5(a), so even though a public entity is providing financial services as well, it is not subject to the FSA.

(2) Financial Services in the Context of GATS

The GATS covers all services sectors including financial services, except services supplied in the exercise of government authority. So the general disciplines and

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(x) Trading for own account or for account of customers, whether on an exchange, in an over-the-counter market or otherwise, the following:
- (A) money market instruments (including cheques, bills, certificates of deposits);
- (B) foreign exchange;
- (C) derivative products including, but not limited to, futures and options;
- (D) exchange rate and interest rate instruments, including products such as swaps, forward rate agreements;
- (E) transferable securities;
- (F) other negotiable instruments and financial assets, including bullion.

(xi) Participation in issues of all kinds of securities, including underwriting and placement as agent (whether publicly or privately) and provision of services related to such issues;

(xii) Money broking;

(xiii) Asset management, such as cash or portfolio management, all forms of collective investment management, pension fund management, custodial, depository and trust services;

(xiv) Settlement and clearing services for financial assets, including securities, derivative products, and other negotiable instruments;

(xv) Provision and transfer of financial information, and financial data processing and related software by suppliers of other financial services;

(xvi) Advisory, intermediation and other auxiliary financial services on all the activities listed in subparagraphs (v) through (xv), including credit reference and analysis, investment and portfolio research and advice, advice on acquisitions and on corporate restructuring and strategy.

[9] According to Paragraph 5(c), "public entity" means:

(i) a government, a central bank or a monetary authority, of a Member, or an entity owned or controlled by a Member, that is principally engaged in carrying out governmental functions or activities for governmental purposes, not including an entity principally engaged in supplying financial services on commercial terms; or

(ii) a private entity, performing functions normally performed by a central bank or monetary authority, when exercising those functions.

obligations under the GATS, including MFN, transparency and commitment to further liberalization negotiations, apply to financial services sector with no doubt. Specific obligations in financial services are related to market access (Article XVI) and national treatment (Article XVII). They apply only to financial services that are inscribed in the Schedules of Commitments of countries where specific commitments on market access and national treatment are listed in the form of limitations or measures applicable. Article XVIII offers the possibility for countries to inscribe additional commitments that are not dealt with under the two previous articles. Some countries have made their specific commitments in accordance with the Understanding on Commitments in Financial Services, which is an optional text containing a "formula" approach to the scheduling of commitments (described below).

In additional to the provisions of Articles XVI, XVII and XVIII, specific commitments in financial services are made in accordance with the Annex on Financial Services that complements the basic rules of the GATS. Paragraph 2(a) of the Annex on Financial Services is a core element of the Annex, which is known as the "prudential carve-out". It recognizes that Members may take measures for prudential reasons, including for the protection of investors, depositors, policyholders and for preserving the integrity and stability of the financial system. However, such measures shall not be used as a means of avoiding a Member's commitments or obligations under the GATS. These

measures do not need to be inscribed in the Schedules of Specific Commitments of Members regardless of whether they are in conformity with any other provisions of the GATS. The "prudential carve-out" provision meets the Members' prudential regulation requirement which is indispensable for financial liberalization. Furthermore, Article XII of the GATS allows Members to introduce restrictions of a temporary nature in the event of serious balance-of-payments and external financial difficulties subject to consultations with other Members.

The GATS also contains an Understanding on Commitments in Financial Services (which results from an initiative by OECD countries). The Understanding represents a very extensive degree of liberalization and aims at pushing further liberalization in financial services sector. It provides an alternative approach to that covered by the provisions of Part III of GATS. Members do not formally "adhere" to it, but may use it as an "alternative approach" to scheduling specific commitments on financial services. Application of the approach must not conflict with the provisions of the GATS. The MFN obligation and commitments to National Treatment of the GATS will apply for the benefit of all Members, including those who have not adhered to the Understanding.

IV. FSA and the Opening-up of China's Financial Sector

Since 1978, China has initiated the policy of reform and opening up. After more

than two decades of market-oriented reform, significant progress has been made in China's economic system. China has changed from a closed central planning economic system towards an open market economy. Over the past two decades, China's financial sector has also changed notably. China's financial reform and opening-up have brought a great deal of dynamism to financial institutions and this has accompanied the process of developing a market economy. Finance has penetrated into all aspects of life and is playing an important role in the national economy. With China's gradual opening-up and rapid economic growth, foreign financial institutions are facing great opportunities in China and expanding rapidly. In 1979, the first foreign bank representative office was established in Beijing, China. By the end of October 2003, there are total 182 foreign bank branches, 209 foreign bank representative offices and a number of other financial institutions operating in China.[10] China's entry into WTO in December 2001 signals the further determination and commitments to financial reform and opening-up.

1. History of the Reform in China's Financial Sector

The reforming process up to now in China's financial sector can be divided into the following three periods, which are in the same pace with China's overall economic reform and opening-up process. The details of the development status and reform progress at each stage are shown in Table 3.

[10] See http://www.cbrc.gov.cn/lingdaojianghua/detail.asp?id=64&keyword=, visited on Nov. 27, 2003

(1) The First Period (1979-1989)

During this period, China's overall economic reform and opening-up were at the experimental stage, so the pace of financial reform was also fairly slow, experimental and only taken gradually.

Prior to 1979, China practiced a Soviet-style mono-banking system. The People's Bank of China (PBOC), apart from being responsible for monetary control as a central bank, handled almost all the lending businesses. Although some specialized banks did exist, they were actually either agents for budgetary grants handed down by the Ministry of Finance (MOF) or business branches of the PBOC. All deposits of state enterprises were held in accounts at the People's Bank. Credit could only be obtained there. All business transactions between enterprises were settled through the People's Bank according to the state plan. The payments of wages could only be made through a separate "wage fund" account[11]. In that highly centralized planning economic system, China's banking system was not modern and played only a limited role whose primary functions were collecting revenue from Stated-owned enterprises (SOEs) and allocating investment through budgetary grants. The PBOC, as the sole bank, played a double role of being the central bank and the financer of enterprises.

From 1979, in the process of establishing a modern banking system, the Chinese

[11] See Wu Jinglian, "*China's Economic and Financial Reform",* in "*Financial Reform in China*", edited by On Kit Tam (Routledge 1995), p 85.

government first removed the monopolistic position of the PBOC by separating out its non-central banking business and establishing four national specialized commercial banks: the Bank of China (BOC, established in 1949, and obtained its independence after 1979), the China Construction Bank (CCB, established in 1979), the Agricultural Bank of China (ABC, established in 1979), and the Industrial and Commercial Bank of China (ICBC, established in 1984). The ABC was established to take over the PBOC's rural banking business and supervisory authority of a network of 60,000 rural credit cooperatives (RCCs) that had been providing small-scale rural banking business, the BOC was delegated to take over foreign currency transactions, the CCB focused on the construction sector, and the ICBC concentrated in the industrial and commercial businesses. In 1983, the State Council of the Chinese Government promulgated *The Decision of the PBOC become Central Bank* and removed ordinary banking businesses from the PBOC. Thus the PBOC was free to function as the central bank. However, it was not until 1986 that the PBOC was explicitly made responsible for monetary policy and the supervision of the financial system including money and capital markets. Apart from the four specialized banks, some diversified forms of banks and non-banking financial institutions were established as well. After 1984, regional banks, trust and investment companies, leasing companies and other non-bank financial institutions were set up. In 1987, two national banks were established (the Communications Banks and the CITIC Bank). Thus, the pattern of a two-tier banking

system with the separated central bank gradually emerged.

In 1980 the People's Insurance Company of China (PICC) re-established domestic insurance, which had been discontinued for twenty years. But stock market had not occurred in this period yet.

(2) The Second Period (1990-1995)

This period witnessed a deeper and more aggressive economic reform and opening-up. Fundamental and progressive reform policies in financial sector were implemented. Reform of the financial system consisted of three major tasks: (a) converting the PBOC into a real central bank; (b) establishing policy banks, separating policy lending and commercial lending, and gradually converting the present specialized banks into real commercial banks, so as to; (c) reforming the management system of interest rates and exchange rates and relaxing control over these rates[12]. These issues are the core for establishing a market-oriented financial system.

In 1994 and 1995, new tax law and new PBOC law were passed, which had strengthened the role of PBOC as an independent regulator. Also in 1994, three policy banks were established[13]. They are given responsibility to make loans in the areas of foreign trade, national infrastructure development and agricultural development according

[12] See Liu Guogang, "*China's economic reform: Successes, challenges, and prospects for the twenty-first century*", in "*China in the Twenty-first Century: Politics, Economy, and Society*", edited by Fumio Itoh, United Nations University press (1997), p 84.

[13] The State Development Bank, the Agricultural Development Bank and the Export-Import Bank.

to government policies, a function that used to be given to the specialized banks. This change was to help specialized banks to operate on a purely commercial basis. In this period, the government allowed the entry of more banks. Some shareholding commercial banks were set up in the first half of the 1990s including the China Merchant Bank, the Hua Xia Bank, and the Everbright Bank. In 1995, the first domestic private bank, the Minsheng Bank, was established by some wealthy business people. Other regional banks also were established in this period, such as the Guangdong Development Bank, the Shanghai Development Bank, the Shenzhen Development Bank, and the Fujian Industrial Bank.

Regarding the foreign exchange system, the dual exchange rate system was abolished in 1993 and the exchange rate was unified since 1994. The new system also abolished the prior approval for the purchase of foreign exchange for trade and trade-related transactions. Businesses involved in trade were allowed to purchase foreign exchange from any designated financial institution.

In 1995, the National People's Congress passed the first comprehensive Insurance Law, which provides a legal and regulatory framework that approximates international standards. Securities exchanges were initiated in Shanghai in 1990 and Shenzhen in 1991, respectively. Two regulatory bodies were established in 1992 to supervise the development of the securities industry. *The National Security Law* was implemented.

These measures helped to boost the stock market.

(3) The Third Period (Since 1996)

External and internal economic environment has changed substantially during this period. The lessons from Asian financial crisis, the domestic macroeconomic situation and the expected WTO accession had sped up the restructuring of China's financial sector.

The Asian financial crisis in 1997 has significant impact on China's policy makers in the aspect of the consideration of financial risk. It is commonly accepted that financial liberalization in a weak institutional environment contributed to the crises. Domestically, this period follows the macroeconomic soft-landing, the adverse impact of the Asian financial crisis on China's export which was previously one of the main growth engines of China's economy.

Under the above-mentioned circumstances, the Chinese government had followed the following sequence to undertake financial reform.

The first step is to reconstruct the central banking system and monetary instruments. In the past, when the presidents of the local branches of the PBOC were appointed or removed, the bank must consult with the local government, which had the right to veto appointments. To further strengthen its authority as an independent central bank and reduce outside influence, the PBOC has undergone a break-through reform at the end of 1998: the 31 PBOC provincial branches were replaced with 9 regional branches. By

doing so, the PBOC has accomplished a historical transition in its administrative regime by replacing its provincial branch network with regional branches set up in accordance with regional economic development. As a result, the local governments' financing channel from the central bank was terminated and the independence of the central bank in implementing monetary policy and financial supervision has been strengthened. The government also adjusted the monetary instruments: credit ceilings were removed, while market-based instruments have been more active.

The second step is to enforce the segregation system of financial regulation by the independent operation between the PBOC, China Securities Regulatory Commission (CSRC, established in 1992), and China Insurance Regulatory Commission (CIRC, established in 1998). This system is regarded as a firewall blocking the over-speculative fund flows and asset bubbles. In 2003, the China Banking Regulatory Commission (CBRC) was established to separate bank regulation from the PBOC.

The third step is to dissolve financial risk at the micro level, which contains recapitalization, stretching out bad assets from the state-owned commercial banks (SOCBs) by asset management companies (AMCs), and internal risk control. One of the most important issues faced by China's banking sector is the existence of a large number of non-performing loans (NPLs)[14] and the resultant capital inadequacy of SOCBs. It was

[14] A four-category classification was used in China for a long time, which consisted of normal, past-due, idle

estimated that at the end of 1997, the amount of NPLs of the four SOCBs totaled RMB 1.3 trillion and the capital adequacy ratio was less than 3% (See Table 7 and Table 8), so the first priority of China's financial reform is to reduce the NPLs and increase capital adequacy ratios. To resolve this problem, the Chinese government has taken several measures. To increase the level of capital adequacy, in 1998 the government issued RMB 270 billion of special bonds and injected this sum into the SOCBs. To dispose of NPLs, in 1999 the government established 4 asset management companies (AMCs), capitalized at RMB 10 billion each, to acquire SOCBs' NPLs. About RMB 1.4 trillion of NPLs (about 15.6% of the combined total of outstanding loans) have been transferred from the SOCBs to the AMCs.

Another eye-catching action was the close of some seriously troubled financial institutions instead of bailing them out. As shown in Table 5, the number of China's financial institutions rose in the 1990s and reached the peak in 1997, then reduced 25% by the end of 2000. For instance, after the collapse of the Guangdong International Investment Trust Company in 1998, the government launched a restructuring program for these companies. Their number declined from 240 in 1997 to 60 at the end of 2002. Many

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and bad with the last three categories being recognized as NPLs. The classification is made based on whether the repayment of the principal and interest has been delayed. In 1999, the international five-category classification system was adopted by the PBOC. The five-category system classifies bank loans according to their inherent risks: pass, special-mention, substandard, doubtful and loss, the last three categories being recognized as NPLs. From 2000, the SOCBs except the ABC began to disclose NPL data under the four-category classification and the five-category classification simultaneously. The China Banking Regulatory Commission stipulates that China's SOCBs and joint-stock commercial banks should adopt the five-category classification system as of 2004.

trust and investment companies, previously the fund-raising arms of local governments or means for banks to avoid regulation, have come under closer examination. Clearing out the rot in the non-banking financial institutions helped improve the soundness of the whole financial system.

Although the capital ratio has been improved except for the Agricultural Bank (Table 8), and the AMCs have made some progress in reducing the NPLs, the four SOCBs have not succeeded in containing the growth of NPLs, on the contrary, it even worsened since the fundamental problems still remained. In 2002 the total NPLs in the four SOCBs had reached RMB 2 trillion (Table 7). In response, at the end of 2003, the Chinese government decided to use $45 billion (RMB 372.5 billion) worth foreign reserves to increase the capital ratios of the Bank of China and the China Construction Bank. The government picked up these two SOCBs over the other two SOCBs because their superior performance[15] would make it possible for earlier public listing. This injection enabled the two SOCBs to have capital adequacy ratios above the internationally recognized standards. In return, the two banks were required to lower their NPL ratio below 15% before 2006. The government's decision to inject money also reflected its determination that there would be no more cash injection, and that the SOCBs should resolve their NPL problems themselves.

[15] The BOC has the smallest asset size with the highest capital adequacy ratio (more than 8%), while the CCB has the best management skills and smallest NPL ratio of 11.84%.

To sum up, China's financial system reform in the past two decades has been characterized by institutional innovation, namely the change from planned financial system to market-oriented financial system and the change from one-tire banking system to two-tire banking system. The structure of China's financial system is shown in Table 4.

The reform in China's financial sector during the past two decades has achieved significant success and paved the way for deepening the continuing structural changes in this sector. However, some major risks in carrying out further reform still exist. The gap between China's financial system and that of the industrial countries is still significant. Intense international competition has just begun. This process is still on the way and cannot be stopped. Accession to the WTO in 2001 is by no means the end of the reforming process. On the contrary, it brings higher requirements and more incentives for China's further financial reforms. Globalization means standard unification, therefore, the reform must move along this path. Success in carrying out further structural changes in line with the requirements of its accession to the WTO will be a key factor in determining the long-term prospects of China's financial industry and the goal of consummating the market economy.

2. Opening-up of China's Financial Services and the GATT/WTO Accession Negotiations

China's opening-up policy in financial sector is not merely for the intention of

resuming its GATT membership or accessing to the WTO. Even if China had no intention to join the WTO, the process of opening-up in financial sector is also inevitable, as long as China wants to continue its reform towards a market-oriented economy. The opening-up of China's financial sector is the integral part and one of the most important parts of China's whole opening strategy. Facing financial globalization, it is the rational choice for China to further open up its economy and benefit from the full-scale contact with the international markets. Foreign financial institutions not only provide an external financing channel for Chinese enterprises, but also facilitate the development of the domestic financial market and set a good example for Chinese financial institutions on how to do business in the international financial market. Also, the entry of foreign banks urges the Chinese regulatory authorities to comply with international standards and to reduce government intervention. However, for China, the role played by foreign financial institutions might be a double-edged sword. While promoting financial deepening in China, expansion of foreign banks' market share might have negative effects on China's financial industry, such as potential shocks to Chinese financial institutions, strengthened transmission of international financial crisis, and reduced capability of the central bank to exercise macro-economic management by using traditional monetary policy instruments.

The processes of opening-up and WTO-accession negotiations are inter-related and inter-accelerating. The opening-up, or market access for foreigners, in China's

financial sector is an intrinsic issue linked to its domestic financial system reform, and at the same time also a major issue in China's GATT/WTO accession negotiations. The following part will review the opening-up of China's financial sector in the context of its GATT/WTO accession negotiations. The details of the opening-up process can be seen in Table 11.

(1) Before China's application for entry into the GATT (1978-1985)

In the past, China's foreign trade dealings and foreign investment mostly came from the former Soviet Union and East European countries. It did not participate in any international financial institutions led by USA or Europe. From the beginning of the opening-up process in the late 1970s, China has gradually improved relations with Western countries, expanding trade with them and inviting foreign direct investment (FDI) to its territory. At the same time, central and a few local governments began to seek foreign capital for their economic development. It is unavoidable for both the foreign investors and Chinese government to deal with foreign banks. Pushed forward by trade and investment, China's financial sector gradually integrated into the global financial system. Thus, as part of the opening-up policy, foreign banks were allowed for the first time to enter into China. However, during this period, the openness for foreign financial institutions is very limited and in a cautious and experimental way, and was only allowed in a few cities. Representative offices became the initial means for foreign banks coming

to China. In 1979, Export-Import Bank of Japan opened a representative office in Beijing, which was the first foreign bank representative office in China after 1949. However, representative offices are only allowed to provide introductions, contacts and service promotion for their head offices' cross-border supply of banking services. They are prohibited from undertaking profit-making activities, though they can eventually help their head offices set up branches, subsidiaries or joint ventures in China.

In April 1985, the first foreign bank branch was set up in Shenzhen by the Hong Kong-based Nanyang Commercial Bank, after the PBOC's announcement of the *Regulations Governing Foreign Banks and Joint Chinese-Foreign Banks in Special Economic Zones* (SEZs)[16]. This Regulation allowed foreign banks to set up branches and local subsidiaries and to establish joint venture banks with Chinese partners in selected cities and SEZs. But their activities were limited to wholesale banking and a limited number of foreign exchange transactions such as foreign exchange deposits and loans for joint ventures, foreign exchange investments and guarantees, and the settlement of import and export accounts.

These were the only forms of access that China offered for foreign financial institutions during this period. Insurance business was monopolized by the PICC. The securities market even did not exist yet.

[16] So far there are total 5 SEZs in China, namely, Shenzhen, Zhuhai, Shantou, Xiamen and Hainan. They are all located in southern China. Shenzhen SEZ, established in 1980, was the first one in China.

(2) During the Uruguay Round of GATT (1986-1993)

Gradual and continuous progresses had been made during this period. More cities were open for foreign banks and more foreign banks entered the Chinese market. Foreign financial institutions were also allowed for the first time to access to insurance and securities sectors in a few cities, although their activities were very limited.

China submitted the application for resuming its GATT membership on 11 July 1986, a few months before the Uruguay Round was launched in October. Since then, the opening-up of its financial services sector had been pushed strongly by the GATT/WTO accession negotiations. China participated actively in the whole round of negotiations. In late 1990, the GATT negotiations on trade in services required the participants to make primary commitments regarding market access to their service sectors. In July 1991 China submitted its first schedule of commitments which covered six services sectors including banking[17]. After further negotiations, in April 1993 China agreed to open more services sectors including insurance[18].

However, China's commitments were fairly limited. Cross border supply and consumption abroad of financial services remained unbound. Regarding commercial

[17] The others were transportation, tourism, offshore oil exploration, advertising and professional services. See Chen (2000).

[18] In 1992 China began to allow foreign insurance companies to operate in Shanghai, the biggest city and the commercial center in China. In that year, an US insurance company, AIG, had received approval to set up a branch in Shanghai.

presence, the establishment of foreign institutions engaged in banking[19] was confined to twelve cities and one province, all located in coastal areas[20]. Foreign insurance companies could only choose Shanghai as the base for their branches or joint ventures.

China made no commitment on securities services, although some foreign securities companies had established representative offices in Shanghai and Shenzhen, to act as brokers of “B” shares[21]. They could also trade in “H” and “N” shares which were listed on the Hong Kong and New York stock exchanges respectively. China’s securities markets were segmented and still in its infancy.

In terms of actual market access, China’s commitments regarding financial services during the Uruguay Round were fairly conservative. It could be categorized as “binding status quo”, which meant merely guaranteeing the existing market conditions, rather than making any further commitment on future financial services liberalization.

(3) Post-Uruguay Round (1994-2001)

After the Uruguay Round was concluded, negotiations for further liberalization in financial services continued among most WTO members. At the same time, China also has implemented a number of liberalization measures in financial services sector during its

[19] China allowed foreign financial institutions to set up one of the following five types of presence to supply banking services: subsidiary of a foreign banks, branch of a foreign banks, Chinese-foreign joint bank, Chinese-foreign joint finance company and totally foreign-owned finance company.
[20] In 1992, Guangzhou and other 6 costal cities were added to the opening-up list for foreigners, which made the number of places open for foreign financial institutions totaled 13.
[21] “B” shares are denominated in foreign currencies (the US dollar in Shanghai and the Hong Kong dollar in Shenzhen), issued only to foreigners but listed and traded on the domestic stock markets.

WTO accession negotiations.

In 1994, the State Council approved the *Regulations on the Management of Foreign Financial Institutions*. At the same time, 11 major inland cities, including Beijing, were opened to foreign banks and financial companies; this made the number of the cities that opened financial services market increased to 24[22]. In response to the increasing pressure from the WTO Members, in late 1996 China began to accept applications from foreign banks to engage in local currency business in the Pudong New Area of Shanghai. China further relaxed its "one branch per city" restriction in Shanghai to enable foreign banks to take advantage of the liberalizing of Renminbi business. In August 1998, China undertook to relax the geographical limitations and business restrictions imposed on foreign banks' local currency services. Shenzhen SEZ was approved as the second pilot city for foreign banks to conduct Renminbi business. It was also announced that controls on inter-bank lending would be eased, foreign banks would be allowed to participate in Renminbi consortium loans, and CDs (certificate of deposits) business would be permitted in the future. But the restrictions on the establishment of subsidiary offices by foreign banks, and on offering services to local customers, remained in force.

By early 1999, 19 foreign banks had been approved for local currency business in Shanghai and 6 in Shenzhen. However, their business was subject to a number of

[22] See Guo Genlong, "*China's Financial Services Trade Policy under the Framework of WTO*", Economics & Management Press, 2002, p. 152

limitations, mainly restrictions preventing them from dealing with Chinese customers and the ceiling on liabilities. Because of these limitations, and the fact that the banks had just started their local currency business, the volume of the Renminbi business was very low compared to their total business volume.

China also issued more licenses to foreign insurance companies. By mid-2001, 17 branches of foreign insurance companies and joint venture insurance companies had been permitted to sell policies in Shanghai and Guangzhou.[23] The securities markets kept on expanding. Although China had made few definite commitments on securities services, it approved the establishment of a joint-venture investment bank,[24] which could supply a wide range of securities services.

For many years there was little progress in China's accession negotiations, mainly due to the difficulties in the negotiations with USA. However, a breakthrough finally occurred. In November 1999, China and USA concluded the bilateral negotiations. China had made more liberalized commitments in that agreement[25], not only had agreed to open up the banking and insurance services sectors, but also foreign securities companies and fund management companies would get access to the Chinese capital market, although limited to holding minority stakes in joint ventures.

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[23] Insurance market in Guangzhou was open for foreigners in 1995.
[24] China International Capital, its major shareholders included the China Construction Bank (42.5%) and Morgan Stanley (35%). See Chen (2000).
[25] http://www.ustr.gov/releases/1999/11/cbchina.html, visited on November 13, 2003.

Having finished negotiating with USA, another most significant trading partner still yet to reach agreement is EU. Foreign ownership in insurance services sector was one of the last hurdles. Finally the bilateral negotiations with EU finished in May 2000. The two agreements—with USA and EU—formed the basis for China's WTO accession package.

In sum, the Chinese government has implemented a number of opening measures and China's financial services market become more open to foreigners during the two decades of opening-up and reform period. Compared to the domestic counterparts, foreign financial institutions in China even enjoy some preferential treatment, including preferential taxes, preferential foreign-exchange deposit interest rates, right to determine service charge, freedom from government administrative control, right to directly seek interbank loans from Chinese-invested banks for Renminbi funds, relaxation of foreign-debt management, direct financing from the international market and waived assumption of specific obligations (such as supporting China's agriculture, helping the poor and saving victims from disasters).

Meanwhile, there were still some restrictions on scope of areas and items of business operation for foreign financial institutions. Before accession to the WTO, foreign financial institutions were subject to the following limitations on business operations:

(a) Restriction on client type: Foreign institutions were not allowed to start

businesses servicing Chinese-invested enterprises and Chinese residents.

(b) Restriction on conducting transactions in certain currencies: Foreign institutions were not allowed to handle Renminbi transactions unless with special permission.

(c) Restriction on operating areas of Renminbi transactions: Experimental transactions could only be conducted in Shanghai and Shenzhen, but from August 1998, the PBOC broadened the scope for foreign banks to conduct Renminbi transactions. Service scope for foreign banks in Shanghai was extended to Jiangsu and Zhejiang Provinces while that in Shenzhen was extended to Guangdong, Guangxi and Hunan Provinces.

(d) Limitation of Renminbi liability: Renminbi liability of foreign financial institutions cannot constitute over 50 percent of foreign-exchange liability.

(e) Restriction on establishment of branch organizations: Limitation on location of establishments was cancelled, but foreign financial institutions can set up only one branch per city, and cannot set up other subordinate operating points.

(f) Restriction on reloaning: Foreign institutions cannot receive financial support from the central bank of China.

As of 2001, there are about 190 foreign banks with branches or representative offices in China.

(4) After Entry into the WTO (since 2002)

As of 11 December 2001, China became a full member of the WTO, after traversing a long and tortured fifteen-year accession path. China is joining as the twelfth-largest exporter and tenth-largest importer of commercial services.[26] It has the largest population and largest potential market among all the WTO members.

Upon entry into the WTO, China has agreed to make substantial market-access commitments in financial services sector, including to adopt WTO rules on financial services trade and to undertake significant liberalization in this sector. The opening-up is mainly the implementation of China's commitments. Now China is opening its financial services market by substantially deregulating both the conditions of entry and the scope of operation for businesses in China. The detailed analysis of the situation of China's opening-up in financial services sector is described in the following part.

After more than 20 years, China's financial reform and opening-up has made great progress. Reform has generated competition and helped to increase overall competitiveness of China's financial institutions and the financial market. Reform has also deepened foreign financial institutions' presence in China; the number of foreign financial institutions in China increased, and has reached a certain degree of scale. Table 10 shows the information of foreign-invested banks' branches in China in 2002. There are 146

[26] See Jeffrey L. Gertler, "*China's WTO Accession—the Final Countdown*", in Deborah Z. Cass, Brett G. Williams and George Barker (editors), "*China and the World Trading System*", Cambridge (2003), p. 64.

foreign banks' branches from 19 countries operating in 20 cities in China. Shanghai hosted the most branches of foreign-invested banks in China (40 branches), followed by Beijing (19), Shenzhen (19) and Guangzhou (15). These branches mostly came from Hong Kong (36), followed by Japan (20), France (16) and USA (13).

When joining the WTO, the Chinese government has set a timetable for progress of opening the financial services industry. Generally speaking, this would be a win-win deal for both domestic and foreign financial institutions. However, the real implications of this event for future financial services sector and to what degree China and foreign countries can benefit from it are still uncertain. Therefore, the coming five years starting from 2001 will be a critical juncture in opening China's financial market.

3. Elements of China's Commitments on Financial Services Liberalization upon Accession to WTO

China's commitments under the WTO represent the consolidation of the 37 bilateral agreements with USA, EU and some other WTO members. These commitments are listed in *the Protocol on the Accession of the People's Republic of China*.[27] In that Protocol, China has made a broad range of commitments to significantly open up its services sector to foreign investment and participation gradually. The financial services sector is being opened up considerably, especially in banking and insurance. The key

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[27] Available at *http://www.wto.org/english/thewto_e/acc_e/completeacc_e.htm*

elements of China's commitments in financial sector contained in the Protocol are summarized as follows (please refer to Table 12 for detailed information).

(1) Banking Sector

Upon accession, foreign financial institutions were permitted to provide foreign currency services, including deposit-taking, loans and other services, to Chinese enterprises by two years after accession. Within five years of accession, foreign financial institutions will be permitted to provide local currency services to Chinese individuals as well. The geographic restrictions on local currency business will be phased out and removed completely within five years after accession. Non-bank financing institutions were permitted to provide auto financing upon accession.

(2) Insurance Sector

Geographic restrictions on foreign firms will be removed altogether within three years and the scope of permitted business activities for foreign insurers will be significantly expanded. Limitations on choice of operating partner will be removed. Foreign firms will be able to provide health, pension and group insurance in life, and all non-life activities except for mandatory third-party-liability auto insurance. Foreign non-life insurers will be permitted to operate as wholly-owned subsidiaries within two years after accession. Foreign life insurers will be required to operate on a joint venture basis, with a maximum equity share of 50 percent. Current restrictions on reinsurance activities

by foreign as well as domestic firms will also be phased out in four years after accession.

(3) Securities Sector

Foreign financial institutions' firms will be allowed to have up to 49 percent equity interest in domestic fund management businesses three years after accession. Foreign underwriters will be allowed to establish joint ventures, with foreign minority ownership not exceeding 33 percent.

V. The Way Ahead

1. Banking sector

After twenty years of reforming and opening-up, China now has an increasingly diversified banking system comprising a central bank together with a growing number of domestic and foreign commercial banks. China's banking system is now among the world's largest, particularly in relation to GDP.

A modern, well-functioning financial system is an essential part of a market economy. China has come to the stage where further financial market reform is critical to its ability of achieving greater structural change in the economy. China's commitments on opening the financial sector to foreign competition under the WTO agreements will force domestic state-owned banks to become more competitive, but will also create greater challenges for managing the complex process of financial system liberalization, especially

banking sector reform.

(1) Structural features of the domestic banks

China's domestic commercial banks can be classified into three segments: four major state-owned commercial banks (SOCBs); eleven joint stock banks (JSBs) and more than 100 city commercial banks (CCBs). Apart from these, China also has a postal savings bank, which takes deposits but does not make commercial loans, and a large network of urban and rural credit co-operatives that provide services similar to those of the commercial banks, but mainly focus on small-and-medium-sized enterprises and the rural areas of China (see Table 4). SOCBs and JSBs are major players in China's financial market. China's banking system has the following features:

Virtually complete public ownership and control. The SOCBs are directly subject to the central government; JSBs have multiple public owners below the central government level. The SOCBs remain overwhelmingly dominant despite the entry of new banks over the past fifteen years. In 1999, the big four accounted for 73 percent of total assets, 83 percent of total deposits and nearly 72 percent of total loans, the JSBs ranked the second if excluding the policy banks (see Table 14). By the end of 2003, two years after China's WTO accession, the SOCBs have remained the dominant position on China's financial market. Although its proportion has declined, the four SOCBs still accounted for 55 percent of total assets, followed by JSBs, 13.8 percent. (Table 13)

Disproportionate concentration of bank lending in the SOE sector and fairly low portion of lending to non-state enterprises (see Table 15). Recently the direct lending to non-state enterprises has grown rapidly, but the share in the total volume is still relatively low, especially compared with their contribution to the GDP.

Virtually exclusive dependence of bank funding on deposits and central bank money. This is particularly a serious obstacle to the development of joint stock and city banks because they received a very small share of PBOC loans.

Limited array of bank products and services. Basic lending to enterprises is the dominant activity of nearly all the banks. The limited diversity makes banks' income and cash flow more sensitive to swings in interest rates and loan demand.

(2) Advantages and disadvantages of domestic banks

The domestic commercial banks possess important competitive advantages in terms of their extensive branch networks for raising deposits and servicing customers; their close relations with and knowledge of their Chinese clients; and their close tie to the government, in particular their priority role in financing SOEs and government infrastructure projects. Furthermore, Chinese banks' capabilities have increased significantly as the result of the gradual but extensive reforming and opening-up policies during the past two decades. The entry of foreign banks and the consequent intense competition have made Chinese banks become more sophisticated and experienced than

before.

Despite these advantages, China's domestic banks now also face the following three major problems that imperil their ability to deal with the increased foreign competition:

Low profitability. By 1999, reported pre-tax profits to assets ratio of the four largest SOCBs ranged between slightly negative to 0.33, which is quite low by international standards. The smaller joint stock banks generally had better performances, but still cannot be satisfactory. Table 16 compares the performance of some commercial banks in mainland and Hong Kong, China.

The low-level of profits is partly attributable to inefficiencies that lead to excessively high costs in bank operations. In particular, the extensive branch networks of the four SOCBs include large numbers of offices that are too small or poorly located. The SOCBs, and to a less extent other commercial banks, also have substantial amounts of excess staff. Table 17 shows the assets/bank employee ratios in China and some OECD countries, which suggest their average labor productivity. The average ratio for China's major banks was 727 million US$ per 1000 staff in 2000, well below the level of industrial countries, and also below that of Mexico and Turkey.

Poor asset quality (high non-performing loans) together with inadequate capital. China' banking sector, particularly the four SOCBs, suffer from substantial numbers of

non-performing loans and low levels of capital adequacy. Since the middle of the 1990s, the Chinese government has paid increased attention to Chinese banks' NPL problems and adopted several measures, including in 1998 a capital injection of RMB 270 billion and in 1999 the establishment of the four asset management companies to transfer NPLs amounting to RMB 1.4 trillion ($169 billion) and at the end of 2003 the injection of RMB 372.5 billion ($45 billion) foreign reserves into two better-performing SOCBs (the Bank of China and the China Construction Bank). Despite some achievements have been made, the banks still retain substantial NPLs (see Chart 3, Table 7) and also have low levels of capital adequacy as a cushion against NPLs (see Table 8). Official capital injections made in 1998, together with the subsequent swap of NPLs for government guaranteed bonds of the AMCs, have brought SOCBs' capital ratios to around 7 percent on average, near to the BIS minimum of 8 percent. However, this minimum requirement is increasingly regarded as insufficient for emerging market economies, many of which have raised their capital ratios to 10 percent or more.[28] Meanwhile, although the AMCs made some initial progress in coping with the NPLs, recovering the remaining (poorer-quality) NPLs is even an extremely difficult task.

The nexus of low capital, high NPLs, and low profitability is a potentially large obstacle to the ability of Chinese banks to the respond to increased foreign competition.

[28] Capital ratio reached 11.4 percent in Thailand at the end of 2000, and was above 12 percent in Malaysia in early 2001. Capital ratios in Hong Kong and the Philippines are also above 12 percent. See OECD (2002).

The financial weaknesses directly limit the capacity of the banks to invest in improvements in their capabilities, to raise funds in domestic or foreign financial markets, and to compete or form alliances with foreign banks.

(3) Strategies to improve Chinese banks' competitiveness

Having recognized the importance of the banking system to the overall economy, the supervisory authorities and the banks themselves have been making strong efforts over the past several years to correct the weaknesses noted above.

Cost cutting and hardware updating. The SOCBs have been closing smaller outlying branches and transfer their business to larger city branches or headquarters. Nearly 45 thousand offices were closed between 1998 and 2002. Major efforts are also being made to cut surplus staff. By the end of 2002, the four SOCBs had cut 250 thousand staff.[29] Banks at all levels are also investing extensively in equipments and other facilities to modernize and improve the efficiency of their operations.

Improving credit quality. With strong encouragement from supervisory authorities, banks have tightened internal controls on lending, and are upgrading their internal accounting and other information systems. A new loan classification standard based on international principles has been gradually introduced. Banks now must base lending on commercial criteria (i.e., according to the repayment ability of borrowers). Starting from

[29]See http://www.cbrc.gov.cn/lingdaojianghua/detail.asp?id=64&keyword=.

2000, credit to SOEs with overdue bank loans was cut off in several provinces; this policy is to be adopted gradually throughout China. To reduce risk exposure, loans must be made against collateral, banks must assess borrower creditworthiness, and loans to a single borrower must not exceed 10% of bank capital. To shield banks from political pressure, individuals and nonblank organizations can not interfere in bank operations. Commercial banks can not give unsecured loans to related parities or provide secured loans on preferential terms. Some banks have even introduced a “lifetime responsibility system”, which could penalize bank managers who are responsible for bad lending practices even after their retirement.

Strengthening bank balance sheets. As mentioned above, the Chinese government has made tremendous efforts to recapitalize banks and take NPLs off their books. Chinese commercial banks are now adopting balance sheet criteria that reflect international practices. For instance, as recommended under the 1988 Basle Accord, risk-based capital ratios of 8% are being maintained, although there is concern among some analysts that the Basle criteria understate the riskiness of assets held. Loan-loss provisions are now to reflect asset quality, and since the beginning of 2001, they may be as high as 100% compared to 1% of loans balances previously. Financial statement definitions are also gradually being brought in line with international standards.

Improving corporate governance. More Chinese firms are listing their shares,

exposing them to market discipline. At present only four Chinese banks are listed: Pudong Development Bank, Shenzhen Development Bank, Minsheng Bank, and China Merchants Bank. So far there is no any SOCB listed, but recently it seems that the Bank of China and the China Construction Bank are planning a listing, especially after the capital injection at the end of 2003. The ICBC, China's largest state-owned commercial bank, may follow in the future. Banks also are required to introduce governing boards and are to be audited by an approval accounting firm.

Strengthening competitiveness. Efforts by domestic banks to strengthen their competitiveness are based on exploiting their key advantages of close ties with and knowledge about domestic enterprises and households. On the corporate side, the objective is to strengthen ties with domestic enterprises with good credit standing, particularly in industries with high growth potential. Efforts in these areas involve formation of alliances among domestic banks or with foreign banks to exploit their complementary advantages. The target customers differ according to the characteristics of the particular banks, with the largest SOCBs focusing on very large SOEs, while joint-stock banks gives more emphasis to small and medium-sized SOEs in their home regions. Banks are also seeking to develop more business with creditworthy non-state enterprises, including private firms. Cash management, foreign exchange, and other services aimed at corporate customers are being developed in order to improve profitability and enhance the

banks' ability to retain their most profitable enterprise clients, including foreign joint ventures that they now serve. Consumer lending, which is now relatively small, is seen as a particularly attractive growth area for domestic banks. During the past several years, banks have been rapidly expanding lending for housing, and more recently for automobile purchases and other consumer durables.

Strengthening SOE finances and management. To prevent rising NPLs, the government is restructuring SOEs. SOEs are encouraged to adopt commercial practices, and some small ones are being privatized. SOEs also must limit spending and no longer can assume that banks will automatically provide financing. As part of this process, nearly 26 million workers were separated from SOEs in 1998-2001 (17 million were rehired, and 3 million retired). In 2001, 460 SOEs were shut down, and $ 6 billon in NPLs were written off. In 2002 nearly $10 billion were spent to close or merge unprofitable SOEs.

(4) Structural features of the foreign banks

Many foreign banks have entered China since 1979. Their organizational forms include representative offices, branches, wholly owned subsidiaries, and Chinese-foreign joint-venture banks. At the end of 1999, there were 248representative offices, 157 foreign bank branches and 13 locally incorporated banks. However, their share in China's banking sector is still very low. In 1999, foreign banks accounted for 1.9 percent of the total bank assets in China (Table 14). In 2003, the share of foreign banks' total assets declined 0.5

percent to 1.4 percent of the total assets (Table 13). However, as mentioned in previous section, China's WTO commitments require the phasing out of several key restrictions on foreign bank operations within five years upon accession. So the situation is still changing and will change more significantly in the near future when foreign banks enjoy more freedom in operating in China.

Compared with the domestic banks, currently the main disadvantages of foreign banks are the relatively small sizes of customer base, branch networks and deposit. This is due in large to the regulatory restrictions placed on them and also their unfamiliarity with the Chinese market. However, foreign banks also have significant comparative advantages, such as good asset quality, superior skills and technology, international expertise, overseas networks and the access to global markets, flexible management structures, good risk controls, and also some preferential policies they enjoy, notably in tax treatment, which are similar to those accorded to the foreign investments in other sectors.

(5) Focus of foreign banks' activities

These comparative advantages and disadvantages of foreign banks have shaped the current operation of foreign banks in China, which can be characterized by the following three features.

First, Foreign bank branches are mainly concentrated in large cities in the coastal area. The number of foreign bank branches in the five major cities (Beijing, Shanghai,

Shenzhen, Guangzhou, Tianjin) accounted for 75 per cent of the total number of foreign bank branches in China in 1999. Three years later, in 2002, there were total 107 foreign bank branches in those five cities, still accounted for 73.3 per cent of the total number of 146 (Table 10). The concentration of foreign banks in the five major cities is mainly due to the restrictions placed on their geographic locations. It also relates to the fact that their major customers are multinational corporations which are mainly operating in the coastal cities.

Second, the main source for the foreign currency loans is the credit from a foreign bank office's offshore parent. The amount of deposits held at foreign bank offices in China accounted for less than 1 percent of total banking system deposits in 1999 and less than 0.1 percent of total Renminbi deposits. Although foreign banks are allowed to borrow Renminbi funds from Chinese banks on the interbank market, it is a costly and insufficient funding source because of the following reasons: borrowing from the market is limited to one and half times of an office's capital; the interest rates in China's interbank market is relatively high, which are above the PBOC lending rate and commercial bank deposit rates; the relatively low liquidity of the interbank market.

Third, most foreign banks in China have focused mainly on wholesale banking and have made significant inroads in areas including trade financing, foreign exchange transactions, and the underwriting of Chinese overseas listed equity and bonds. This

reflects the various restrictions placed on their activities, on the other hand it also shows the comparative advantages foreign banks enjoy in these areas. Foreign banks have been the primary source of foreign currency loans for multinational corporations and trading companies. By 2000 they accounted for 23 percent of all foreign currency denominated loans in China. Foreign banks also offer a range of other services to multinational corporations, which are important to foster and maintain relationship with their customers worldwide. Foreign investment banks have dominated the underwriting business of Chinese overseas listed equity and bonds, taking up over 90 percent of market share in this area. Foreign banks also offer a range of products that are not usually offered by Chinese banks, such as loan syndication for working capital, property development and project finance.

China's WTO accession commitments are expected to redefine the activities of foreign banks and accord them in principle something approaching "national treatment". Foreign banks will be allowed to conduct local currency business to domestic individuals five years after China's accession to the WTO. In retail banking, the highly profitable segments of the market such as mortgage financing or fee-based businesses like credit cards will be most attractive to foreign banks.

However, these are not the markets that can be occupied easily. Chinese banks are also acquiring advanced technology and skills quickly, so that they could be able to offer

products competitive with those available from foreign banks to their established customers. Chinese banks have already started paying more attention to consumer loans and credit card business. Regarding the Renminbi business, WTO provisions do not directly affect several major current constraints on the ability of foreign banks to conduct local currency business. In particular, several regulatory provisions, including required ratios of foreign currency borrowing to domestic lending, and the ratio of domestic currency lending to an office's capital, are not ruled out by WTO provided they are not applied in a discriminatory manner. So long as these regulations are maintained, the ability of foreign banks to fund domestic lending by swapping foreign currency or borrowing from the money market will remain quite limited. The restrictions will become less binding if foreign banks are able to attract substantial funds from Chinese enterprises.

(6) Prospects of China's banking sector

As discussed above, both the domestic and foreign banks have their own compative strengths and weaknesses, which determined their different advantageous businesses. For example, lending to domestic enterprises requires ample and reasonably priced access to local currency funding and reasonably good knowledge of the operations and conditions of the borrower, which are clear advantages of Chinese banks. However, foreign banks have the more clear-cut advantages in terms of the provision of risk management services and other sophisticated financial products as well as the ability to

access to overseas markets.

These comparative advantages and disadvantages provide an indication of where foreign banks are most likely to make significant inroads. For example, foreign banks are unlikely to become major players in SOEs and consumer lending, at least not for a considerable time after full liberalization. In contrast, foreign banks have the potential to make large inroads in domestic currency lending to joint ventures, which is one of the major incentives for them to expand operations in China, and continue to maintain the share on foreign currency lending to joint ventures. They are also likely to become major players in foreign exchange services, management consulting, risk management, and some securities-related activities. Compared to local currency lending, these activities are much less hampered by limited access to local currency funds and expose much less bank capital.

Based on the above-mentioned observation, it seems that in the near future, even after the Chinese banking sector is wholly open according to the WTO accession commitments, the foreign banks are likely to play an important but not dominant role in China. The Chinese banks, even are facing more severe competition from foreign rivals, will still act as a key player.

However, one notable thing is that the current advantages and disadvantages are subject to change over time. As has happened in other countries, domestic Chinese banks are likely to absorb skills, experiences, innovations, and technology brought in by their

foreign competitors. This learning process will increase their competitiveness versus the foreign banks over time. At the same time, foreign banks are also accumulating experiences and getting more familiar with Chinese markets. Another important factor that should not be ignored is the changes in the external environment, which will largely shape the development and performance of foreign and domestic banks. These changes may be caused by China's trade and investment liberalization and by the content of economic and political reforms. For example, foreign banks' participation in SOEs lending is likely to expand if and when the reform of SOEs achieve success and the performance of SOEs has been improved significantly. In fact, the improvement in the quality of the markets and customers that the banks serve are crucial for the development of both foreign and domestic banks.

(7) Policy considerations for China's banking reforms

To insure a "win-win" outcome in China's banking sector after the accession to the WTO, the following issues should be considered as high priorities for policymakers to address.

Accelerating the restoration of financial soundness to the domestic banks. A reasonable goal would be to reduce NPLs of SOCBs, JSBs and CCBs to no greater than 10 percent by the time restrictions on foreign bank local currency lending to domestic enterprises are lifted, and to raise their capital levels to at least 8 percent initially. Since the

huge NPLS of the SOCBs were due in large to the long-existed policy loans to the poor performed SOEs, it is impossible for the banks to write off these loans through their operation, so a short-term measure that the government may consider is to undertake a further carve out of non-performing loans. In terms of long-term policy consideration, the government should facilitate the listing of banks as a means of injecting capital. By and large, government support should be structured as far as possible to provide incentives for domestic banks to strengthen their governance structures and to improve lending standards, loan monitoring and risk management.

*Pursuing a more active strategy to encourage the development of JSBs and CCB*s, increase their scope and overall share of the market. One of the priorities is to increase the share of new funds going to and loans from JSBs and other smaller banks.While likely to remain the largest players for the foreseeable future, the decline in market share of the SOCBs should be regarded as a natural and desirable development.

Continuing efforts to remove non-commercial considerations from bank lending and to tighten bank-lending standards. One possibility is to expand the role of policy banks in lending to exceptionally risky or financially troubled SOEs that need to be maintained, or to create separate agencies to guarantee loans for such purposes.

Accelerating the development of the domestic money channels needed to facilitate transfers of funds among financial institutions and regions. The interbank and other

money markets need to become both larger and more flexible over the coming years in order to facilitate the expansion of JSBs and other small banks.

Addressing the problem of uneven development among regions. China's WTO – accession commitments apply to the country as a whole, not just to certain regions. Poorer inland provinces are not even on an equal level in competing with coastal regions, let alone the much stronger foreign competitors. There has been an unequal distribution of benefits and costs of greater openness as far as regional economies are concerned. There will be increased pressures to balance regional and income disparities to maintain social stability. To address the gap between the inland and coastal area, the government should provide some policy incentives to encourage banks to expand their networks and transfer technological and managerial expertise to this region.

2. Insurance Sector

It is well recognized that insurance services play an important role in a modern economic system. Their contributions can be categorized in three key aspects: first, to provide an efficient mechanism for the transfer of risk; second, to provide a means for mobilizing long-term savings and investing them profitably; third, to complement state social insurance programs, especially in the areas of pension, disability and health care financing.

During the negotiations of China's accession to the WTO, one of the last hurdles

for China to join the WTO was the openness of Chinese insurance market, which shows the significant importance of Chinese insurance market to the global community. By mid-2001, there were 37 companies licensed to supply insurance on the Chinese market, 20 among them were allowed to supply life insurances and 17 non-life insurances. Of these, 17 were foreign insurers operating either through joint ventures or branch operations (Table 18).

(1) Features of China's insurance market

Fast growth rates. China has one of the highest growth rates in insurance sector in the world. The insurance market has grown sharply in China from the early 1980s to 2000, with the annual growth rate over 30 percent [30]. The growth rate for insurance premiums was 14.4 percent in 2000[31]. Considering the low starting point and the rapid economic growth, it is reasonable to expect the market to grow above 10 percent annually over the next decade.

Relatively small market size with huge potential. Despite its rapid growth, the size of China's insurance market is still relatively small compared with that of developed countries. China's insurance industry is still only a small part of the entire economy. In 2000, the total insurance premiums income was 160 billion RMB, accounting for less than 1.8 percent of China's total GDP. That ratio was 11 percent in Japan and 8 percent in the

[30] See OECD (2002), p. 277-278.
[31] Lai (2002)

United States[32]. The current small market size is because of the underdevelopment throughout recent history. However, considering the rapid growth rates and the huge market potential of more than 1.3 billion people, the size of China's insurance services market will expand rapidly in the near future.

Changing market structure. Before 1996, spending on non-life insurance was higher than life insurance, but since then the life insurance has grown much more quickly, the size of life insurance market exceeded the size of non-life insurance market after 1996[33]. One of the major reasons is the changes in the state pensions system in 1997, which allowed life insurance companies to offer supplementary pensions to the state system. In 2000, life insurance accounted for 63 percent of the total insurance premium, and non-life accounted for 37 percent. This market structure already resembled that of the industrial countries.

High market concentration. Only a few companies dominate the market. In 2000, the three largest Chinese insurance companies had a 97.1 percent share of the non-life market and a 99.5 percent share of the life insurance market (Table 19). Hence the combined market shares held by the other Chinese-owned and the foreign-owned insurance companies and joint ventures were fairly small. The high concentration caused

[32] See OECD (2002), p. 279 and the *Asia Times* (http://www.atimes.com/reports/CB16Ai01.html, visited on November 26, 2003)
[33] See OECD (2002), p. 278.

insufficient competition in this sector.

Limited investment channels for insurance premiums. The 1995 Insurance Law tightened up the regulations on insurance companies' investment activities. Under the law, the investment was restricted to bank deposits and government bonds. Other investments required official approval. Later this limitation was loosened and the insurance funds were allowed, on a limited scale, to invest in corporate bonds and on stock market directly. The current investment channels are limited to bank deposits, government bonds, corporate bonds, and securities investment funds. Among them, bank deposits are the main investment means. At the end of 2000, Chinese insurance companies had invested RMB 250 billion in bank deposits, government bonds and mutual funds, and half of them went to bank deposits[34].

(2) Policy considerations after the WTO accession

Like the banking sector, China's insurance sector is also facing the challenges of adjustment imposed by the WTO accession. China has also made notable commitments on insurance services opening-up. This liberalization process and the foreign participation in China's insurance markets bring in at the same time the intensified competition and new technology and expertise. Learning from and adopting these advanced technology and expertise is important for the development of Chinese insurance industry. Domestic

[34] See Lai (2002).

insurance companies are making serious efforts in adopting international business practices to adjust to the intensified competition. For the regulatory authorities, there are a number of policy issues that worth considering seriously.

Diversification of foreign players. Most of the existing and newly approved foreign insurance companies are either from North America or Europe. The authorities should consider opening the insurance markets to insurance companies from various countries and regions throughout the world. Since now most are from North America and Europe, the authorities may open the markets to more Asian insurance companies. This consideration is beneficial in terms of both industrial and national security concerns. For domestic insurance industry, the exposure to various competitors from different countries can broaden their views and understanding and have chance to know different technological and managerial know-how. In terms of national security, by doing so can reduce the dependence on the limited number of countries or regions.

Regulations on investment channel. In many other countries, insurance funds, especially the life insurance, are the most important institutional investors on securities market. However, as mentioned above, currently the main investment channels for insurance companies are bank deposits and bond market, investing on securities market is under strict regulation. This policy is appropriate for the current stage of the insurance investment environment.

Recently some insurance companies have pushed changes in regulations so that they could increase their proportion of investment on the stock market to expect the higher returns on investment. The authorities should be very cautious on this issue. Hastily loosing up is inimical to the Chinese insurance industry. The objective of investment in the insurance industry should first be safety. It may be tempting to invest on stock market when stock market is performing well, but stock market investment is very risky. When stock market becomes bearish, it may cause the bankruptcy of insurance companies. Currently Chinese insurance companies still lack expertise in assessing risk when investing on stock market. Another limitation is that China's securities market is still at its infant stage. Under the current situation, it is appropriate for the authorities to carry out a prudent policy. These regulations can be relaxed when Chinese insurance companies become more financially sound and the stock market becomes more mature.

Developing guaranty fund system. With the more severe foreign competition, there exit a high likelihood that a few domestic insurance companies may go bankrupt. To protect policyholders, it is important to develop a guaranty fund system at national level.

Compensate for inadequate consumer knowledge. The entry of foreign insurance companies has greatly broadened the range of insurance services that they provide to the Chinese consumers. Many different types of new life insurance products, such as universal life insurance and variable life insurance, have been introduced into China. Chinese

consumers benefit from the variety of choices. However, it should be noted that average consumer does not have sufficient knowledge to understand all of the provisions and options in an insurance policy. The authorities should formulate regulations to ban various types of inappropriate sales practices such as twisting and deceptive or false advertising. On the other hand, the authorities also should provide adequate and necessary information for ordinary consumers.

VI. Conclusion

Financial services are playing a more and more important role in modern economies. The more vigorous an economy is, the larger size of financial services trade can be seen in that economy. Furthermore, nowadays the financial services markets are becoming increasingly global, and international financial markets are growing more rapidly than domestic markets.

Financial services sector has experienced rapid development in recent years. This rapid development is mainly fueled by technological innovations and financial deregulation. Technological innovations, particularly the widespread use of computer and Internet, have made the fast development and renovation in financial services sector physically possible. Deregulation, accompanied by re-regulation in terms of stronger prudential and transparent rules and competition policy, is crucial for the healthy and

sustainable development in financial services sector.

From economic perspective, trade in goods and trade in services follow the same economic rules, they both can significantly benefit from trade liberalization through specialization on the basis of comparative advantage and the realization of economies of scale and scope. Trade liberalization brings in efficiency and stability in financial services sector, promotes better macroeconomic policies and government regulations, and improves the allocation of inter-temporal and inter-national resource.

In current multinational trading system, the GATS is the only multilateral and legally enforceable agreement governing international services trade. As an important and integral part of trade in services, financial services trade also abides by the principles and disciplines of the GATS. Thanks to the GATS and the FSA, international financial services have become safer, better-ordered, more transparent and predictable. However, since the GATS, especially the FSA, is also the result of great compromises, it is much less than the GATT in terms of the degree of liberalization. More efforts need to be made in the new Round for the purpose of a freer and more open financial services trading system.

China has started the reform and opening-up policy since late 1970s. Now it has become one of the fastest growing economies in the world. Financial reform and opening-up plays a key role in China's overall economic reform and opening-up process and keep

the same pace with it. However, compared with the overall economic reform process, China's financial reform is much more cautious, and the policy-makings and practices are always under the strict control of the central authorities.

China's reform and opening-up policy in financial sector is not oriented by its GATT/WTO accession negotiations. Nevertheless, the reform and opening-up process and the GATT/WTO accession negotiations are inter-related and inter-accelerating. After a 15-year marathon negotiation, China has become a full member of the WTO since December 11, 2001. This is a historical issue in China's financial reform and opening-up history, for China's commitments on financial services liberalization upon the accession will have far-reaching influence on the overall financial reform and opening-up process, and will reshape and accelerate this process as well.

Banking sector is the core of a financial system. China now has an increasingly diversified multi-layered banking system which is among the world's largest. Domestic state-owned banks have the vast majority share in China's banking sector. The reform and opening-up in China's banking sector over the past two decades has significantly increased Chinese banks' capability, making them much more sophisticated and experienced than before. Apart from that, Chinese commercial banks also have some other particular advantages against their foreign competitors, such as the extensive branch networks, the close relations with and knowledge of their Chinese clients, and the close tie

to both central and local governments. However, China's domestic banks also have some big problems, including inadequate capital, high NPLs, and low profitability. These financial weaknesses directly limit their capability to compete with foreign banks. Furthermore, they may endanger domestic banks if they failed to clear up those weaknesses. Gratifyingly, China's supervisory authorities and the banks themselves have been making great efforts in the past several years to correct those weaknesses.

Meanwhile, more and more foreign banks are entering China. Compared with the Chinese state-owned commercial banks, they have remarkable comparative advantages such as good asset quality, superior skills and technology, international expertise, overseas networks and the access to global markets, flexible management structures, and good risk controls. But mainly due to the regulatory restrictions placed on them and their unfamiliarity with the Chinese market, so far the share of foreign banks in China's banking sector is still relatively low. However, subject to China's WTO commitments, several key restrictions on foreign bank operations will phase out within five years after the accession, so the situation may change significantly in the near future.

Both the domestic and foreign banks have their particular strengths and weaknesses. This determines their different advantageous businesses, and also provides an indication of where foreign banks are most likely to make significant inroads. By and large, it seems that even after the Chinese banking sector is wholly liberalized in the near

future, the foreign banks are likely to play an important but not dominant role in China, and the Chinese banks will still act as a key player. There are two more things worthy noticing: first is that the current advantages and disadvantages are subject to change over time; second is that the changes in external environment, which may be caused by China's trade and investment liberalization and by the contents of economic and political reforms, will largely reshape and redefine the development and performance of both foreign and domestic banks.

To insure a win-win outcome in China's banking sector after the accession to the WTO, policymakers may consider the following issues as high priorities: accelerating the restoration of financial soundness to the domestic banks, especially reducing NPLs and raise capital levels; encouraging the development of joint stock banks and city commercial banks, increasing their scopes and overall share on the market; removing non-commercial considerations from bank lending and tightening bank-lending standards; accelerating the development of the domestic money channels needed to facilitate transfers of funds among financial institutions and regions; addressing the problem of uneven development among regions.

Insurance services sector is another important financial segment in a modern economic system, which provides an efficient mechanism for the transfer of risk, mobilizes long-term savings and invests them profitably, and complements state social

insurance programs. China has one of the highest growth rates in insurance sector in the world and is expected to keep growing rapidly over the next decade. However, compared with the developed countries and China's own economic size, China's insurance market is still in a relatively small size and has huge potential. Other important features of China's insurance market include: changing market structure, i.e., the size of life insurance market has exceeded that of non-life insurance market over the past several years; high market concentration, i.e., only a few number of companies have dominated the market; limited investment channels for insurance premiums, i.e., bank deposits are the main investment means.

China has also made notable commitments on the liberalization of insurance services upon its WTO accession. Similar to the banking sector, China's insurance sector is also facing both challenges and chances. The opening-up process and the foreign participation in China's insurance markets brought in the intensified competition and also the new technology and expertise. Chinese insurance companies are making serious efforts to adopting international business practices and win the competition. For the regulatory authorities, the following issues are worthy considering seriously: first, diversifying foreign players, so as to learn different technological and managerial know-how, and reduce the dependence on the limited number of countries. Second, being prudential about the deregulation on investment channel. This is because that stock market

investment is very risky, the Chinese insurance companies still lack expertise and China's securities market is still at its infant stage. Third, developing guaranty fund system at national level. Last, assisting ordinary consumers to obtain adequate and necessary information.

* * *

The current world economy is continually moving towards a global economy. The attempt of keeping autarkical by any single nation is unlikely to come through. However, the globalization of world economy does not mean that each national economy would lose its independency, on the contrary, each country is making every effort to strengthen its own economy so that it can obtain advantageous position over other countries and thus gain more benefits in economic exchange and market competition. So even in the process of world economic globalization, for each individual nation, the very fundamental interest is the interest of its own nation.

Financial services liberalization is part of the world economic globalization. The negotiation and the conclusion of the GATS and its Financial Services Agreement is a remarkable success in the current world trading system and has contribute significantly for the development of world financial services trade. However, it is by no means a full success and we are far from self-satisfaction. In a modern economy, financial services trade is much more important than merchandise trade and is more related to a nation's

fundamental interests. In current world, a few countries have the absolute advantages over the rest countries in financial services sector. This is the stimulant for some countries to push hard financial services liberalization and also the reason for some other countries to hesitate to do so. In future negotiations in the WTO, the concerns of the both groups should be taken into account and a balanced solution is crucial for the future liberalization process.

In the case of China, the 20-year's reform and opening-up in financial services sector is fruitful, China's entry into the WTO reflects further its determination to melt into the world economic system. Although the way ahead is not always smooth and some chronic problems still exist in China's financial services sector, the liberalization process in China's financial sector is unreversed. All in all, the two-year experience in the WTO is cheerful both for China's financial industry and for foreign participants. In terms of the future, it might not as good as some people have expected, but it is definitely not as bad as some other people have conjectured.

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Table 1: Share of Employment in Financial Services

(In percent of total employment)

COUNTRY	1970	1980	1985	1990	1995
Canada[a]	2.4	2.7	2.9	3.0	3.2
France[b]	1.8	2.6	2.9	2.8	2.7
Germany (former federal republic)	2.2	2.8	3.0	3.0	3.3
Japan	2.4	3.0	3.2	3.3	3.1
Singapore[c]	--	2.7	--	--	5.0
Switzerland[d]	--	--	4.6	4.8	5.3
United Kingdom	--	3.0	3.5	4.6	4.3
United States[e]	3.8	4.4	4.7	4.8	4.7

Source: WTO, Opening Markets in Financial Services and the Role of the GATS, 1997.

[a] 1992 instead of 1996. [b] 1996 instead of 1995. [c] 1978 instead of 1980.[d]
1994 instead of 1996. [e] 1994 instead of 1996.

Table 2: Share of Value-Added in Financial Services

(In percent of GDP)

COUNTRY	1970	1980	1985	1990	1995
Industrialized Countries:					
Canada	2.2	1.8	2.0	2.8	2.5
France[a]	3.7	4.4	4.3	3.5	3.2
Germany (former federal republic)	3.2	4.5	5.5	4.8	5.5
Japan[b]	4.3	4.5	5.5	4.8	5.2
Switzerland[c]	--	--	10.4	10.3	13.3
United States[d]	4.0	4.8	5.5	6.6	6.6
Developing Countries:					
Colombia[e]	--	--	--	2.9	2.9
Ghana[f]	5.5	--	8.7	9.2	--
Hong Kong (China)	--	6.9	6.1	6.6	9.4
Mauritius[g]	--	--	--	4.4	5.2
Singapore[h]	--	5.0	--	--	12.0
Sri Lanka[i]	--	--	--	4.6	6.8
Thailand[j]	--	--	--	4.0	7.8

Source: WTO, Opening Markets in Financial Services and the Role of the GATS, 1997.

[a] 1996 instead of 1995;
[b] Figure for 1995 excludes insurance services.
[c] 1993 instead of 1995.
[d] 1994 instead of 1995.
[e] 1992 instead of 1990; 1994 instead of 1995.
[f] 1971 instead of 1970; 1983 instead of 1985;
[g] 1987 and 1993 respectively;
[h] 1978 instead of 1980.
[i] 1994 instead of 1995;
[j] Excludes insurance services.

Chart 1: Total Banking Assets, 1994 (US$ in billion—logarithmic scale)

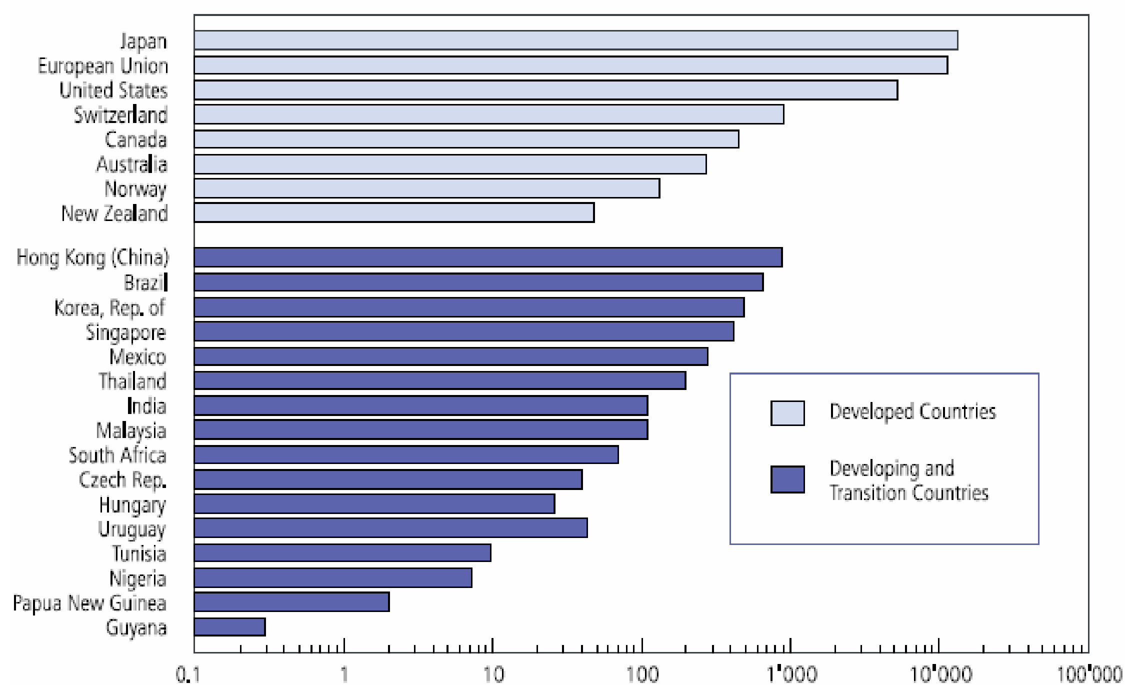
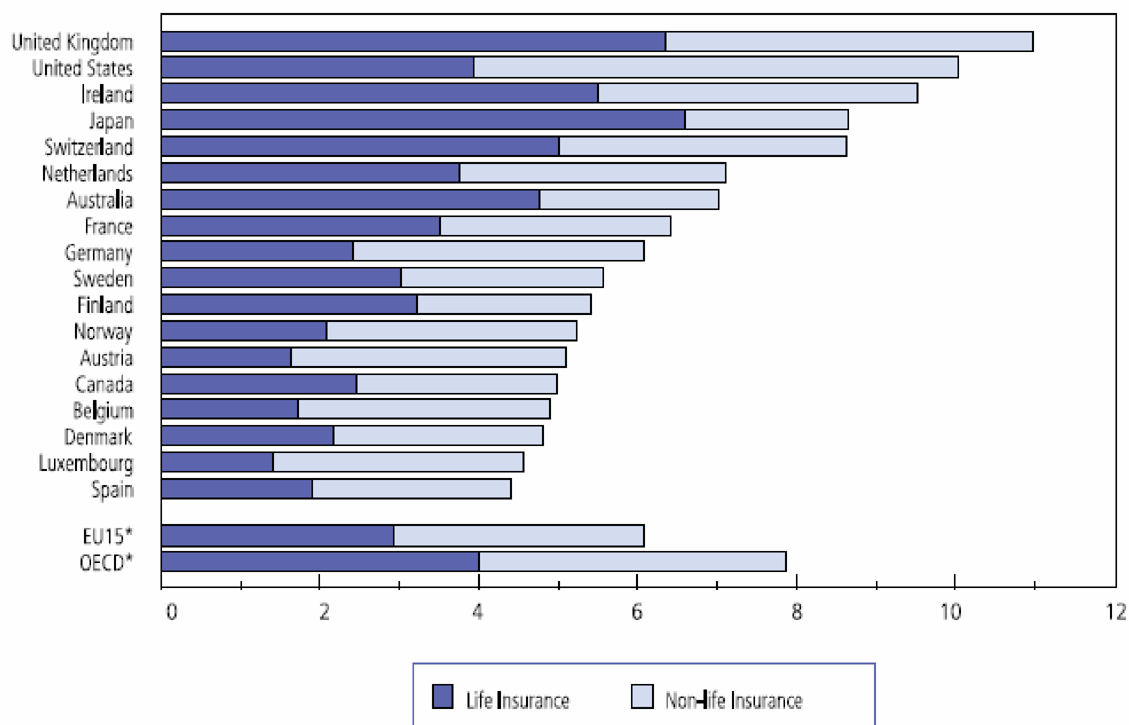


Chart 2: Insurance Premiums as Percentage of GDP, Average 1987-1994



Source (Chart 1 and 2): WTO, Opening Markets in Financial Services and the Role of the GATS, 1997.

Table 3: Development Stages of China's Financial Reform

Stage	Major Contents of Financial Reform	Background
1979-1989	1. From 1979, China resumed and established specialized national banks, building up a diversified financial institution system. 2. Establishment of the State Administration of Foreign Exchange (1979) 3. Introduction of foreign financial institutions (1979) 4. Establishment of three national specialized commercial banks (1979) 4. Resumption of domestic insurance business (1980) 5. The State Council decided that the People's Bank of China shall be officially obligated to perform functions of the Central Bank (1984) 6. Establishment of the Industrial and Commercial Bank of China (1984) 7. two national banks were established (the Communications Banks and the CITIC Bank, 1987)	In 1978, the 3rd Plenum of the 11th Chinese Communist Party Congress adopted Deng Xiaoping's policy of economic reform and opening-up.
1990-1995	1. China Securities Regulatory Commission was established to separate securities regulation from the People's Bank of China. (1992) 2. Establishment of three national policy banks to be in charge of policy-oriented financial business. (1994) 3. Establishment of China Minsheng Bank, China's first private bank. (1994) 4. Enforcement of the Law of the People's Bank of China and the Commercial Bank Law. (1995)	1. In 1992, at the 14th Chinese Communist Party Congress and Deng Xiaoping's southern China tour confirmed the development model for the socialist market economy. 2. In 1993, the 3rd Plenum of the 14th Chinese Communist Party Congress decided to deepen financial reform build a new financial system and enhance financial legislation construction.
1996-	1. Opening of the scope of areas where foreign banks may conduct Renminbi transactions (Pudong, Shanghai in 1996; Shenzhen in 1998) 2. China Insurance Regulatory Commission was established to separate insurance regulation from the People's Bank of China. (1998) 3. Cash injection of RMB 270 billion to the four SOCBs by issuing special bonds (1998) 4. Setting up of asset management companies to clean up bad assets at the four SOCBs. (1999) 5. Promulgation of the new version of the Statute of Foreign Financial Institution Management in December 2001. 6. China Banking Regulatory Commission was established to separate bank regulation from the People's Bank of China. (2003)	1. Asian Financial Crisis in 1997. 2. China became an official WTO member in December 2001

Table 4: China's Financial System

People's Bank of China (Central Bank)			
China Banking Regulatory Commission	Banking System	Policy Banks	State Development Bank of China
			Agricultural Development Bank of China
			Export-Import Bank of China
		State-owned Commercial Banks	Industrial Bank of China
			Bank of China
			China Construction Bank
			Agricultural Bank of China
		Joint Stock Commercial Banks	Bank of Communications
			China Merchants Bank
			China Everbright Bank
			CITIC Industrial Bank
			Hua Xia Bank
			Minsheng Bank
			Other Regional Banks
		City Commercial Banks	
		Rural Commercial Banks	
		Housing Saving Banks	
		Foreign Banks	Foreign-Invested Banks
			Foreign Bank Branches
			Sino-Foreign Joint Venture Banks
	Credit Cooperatives	City Credit Cooperatives	
		Rural Credit Cooperatives	
	Other Non-bank Financial Institutions	Trust Investment Companies	
		Finance Companies	
		Financial Leasing Companies	
		Credit Guarantee Companies	
		Postal Savings Institutions	
		Pawnshops	
	Foreign Non-bank Financial Institutions	Foreign-Invested Finance Companies	
		Sino-Foreign Joint Venture Finance Companies	
		Foreign-Invested Non-Operating Financial Institutions	
China Insurance Regulatory Commission	Policy Insurance Company	China Export and Credit Insurance Corporation	
	Commercial Insurance Companies	People's Insurance Companies of China	
		Foreign-Invested and Joint Venture Insurance Companies	
		Other Insurance Companies	
		Insurance Fund Organizations	
	Insurance Brokers		
	Insurance Agents		
China Securities Regulatory Commission	Securities Companies		
	Security Exchange Centers		
	Investment Fund Management Companies		
	Securities Registration Companies		

Table 5: Numbers of China's Financial Institutions, Securities Firms and Listed Companies

Year	Financial Institutions	Securities Firms	Listed Companies
1991	188,559	66	14
1992	181,959	87	53
1993	199,618	91	183
1994	213,760	91	291
1995	221,480	97	323
1996	225,063	94	530
1997	226,145	90	745
1998	212,090	90	851
1999	196,772	90	949
2000	170,311	101	1088
2001	118,726		1160

Sources: 2002 China Statistics Almanac, China Statistical Publishing House
1999, 2000, 2001 China Securities Market Report, China Financial Publishing House

Table 6: Market Shares of the Four SOCBs

Item	1999	2000	2001	2002
Balance of Deposits (%)	83.0	70.7	67.8	59.6
Balance of Loans (%)	71.7	64.8	62.8	56.6
Total Assets (%)	73.2	84.0	82.6	62.0

Source: Almanac of China's Finance and Banking, 2000, 2001, 2002, 2003.

Table 7: Ratios of NPLs in the Four SOCBs

	1997	1998	1999	2000	2001	2002	2003(Sep.)
Ratio of NPLs (%)	25	10	25	25	25.3	25.3	22.2
Total Loans (¥ 100 million)	51458	62476.8	65819.6	65207.8	70577.8	80361.2	90000
Amount of NPLs (¥ 100 million)	12864.5	6247.7	16454.9	16301.9	17644.4	20331.4	20000
NPLs/GDP (%)	17.2	7.9	20	18.2	18.4	19.8	17.1

Source: Summarized from speeches of the PBOC's governors during 1998-2003

Table 8: Capital Adequacy Ratio of the SOCBs

	1997	1999	2002
Industrial and Commercial Bank of China	2.55	5.7	5.54
Bank of China	4.70	3.0	8.15
China Construction Bank	2.73	2.5	6.91
Agricultural Bank of China	2.14	5.1	1.44

Source: Annual Report of the four banks.

Table 9: Profits on Asset of China's Banking Sector

Year	SOCBs	Policy Banks	Joint Stock Commercial Banks	Foreign Banks
1998	0.10%	0.11%	0.97%	--
1999	0.17%	0.15%	0.64%	2.69%
2000	0.25%	0.51%	0.49%	1.92%
2001	0.20%	0.49%	0.49%	2.26%
2002				

Source: Almanac of China's Finance and Banking 1999-2002

Table 10: Number of Foreign-Invested Banks' Branches (2002)

Country (Region)	Shanghai	Beijing	Shenzhen	Guangzhou	Tianjin	Xiamen	Dalian	Qingdao	Shantou	Zhuhai	Fuzhou	Wuhan	Nanjing	Chengdu	Haikou	Kunming	Yinkuo	Suzhou	Xi'an	Chongqing	Total
Hong Kong	4	2	8	4	1	3	3	2	2	1	2	1			1		1		1		36
Japan	4	3	3	1	3		4	1										1			20
France	5	1	2	3	3	1						1									16
USA	4	4	1	2	1	1															13
Singapore	3	2	1	1	1	2								1							11
Korea	3	1			4		1														9
Germany	5	1		1																	7
UK	1	1	1		1	1				1			1								7
Belgium	2		1	1							1										5
Thailand	1		1			1			1							1					5
Netherlands	2	1	1																		4
Canada		1		2																1	4
Australia	1	1																			2
Italy	2																				2
Austria	1																				1
Philippines	1																				1
Malaysia	1																				1
Portugal										1											1
Switzerland	1																				1
Total	40	19	19	15	14	9	8	3	3	3	3	2	1	1	1	1	1	1	1	1	146

Source: China Financial Almanac 2003.

Table 11: Summary of China's Financial Opening-up

Period	Major contents of financial opening-up
Pre-1978	1. China mainly introduced funds and technology from the former Soviet Union and Eastern European countries. 2. Central control system of exchange rates and foreign-exchange transactions. 3. No existence of foreign financial institutions
1978-1985	1. To respond to need of funds for reform and opening, China began to introduce foreign capital on a large scale, initially foreign borrowings and international financial-institution loans prevailed, and foreign investment also commenced. 2. From 1979, China allowed foreign financial institutions to set up representative offices in open cities like Beijing, Shanghai and special economic zones. 3. In 1980, China joined the International Monetary Foundation and World Bank. 4. In 1985, the State Council promulgated the Regulations Governing Foreign Banks and Joint Chinese-Foreign Banks in Special Economic Zones. 5. In 1985, the first foreign bank branch was set up in Shenzhen by the Hong Kong-based Nanyang Commercial Bank.
1986-1993	1. In 1986, the State Council promulgated the Rules for Encouraging Foreign Investment to enlarge foreign direct investment. 2. In 1986, China joined the Asian Development Bank. 3. From 1990, China began to expand operating areas and business scope of foreign financial institutions. 4. In 1992, China hastened economic reform and opening, doubling foreign-direct investment.
1994-	1. In 1994, China launched its foreign-exchange structure reforms, including implementation of single exchange rate system, adoption of bank-exchange settlement system, cancellation of foreign-exchange fractional detainment system and established the China Foreign Exchange Center. 2. In 1994, the State Council promulgated the Statute Governing Foreign Financial Institutions. 3. In 1996, the People's Bank of China promulgated the Implementation Rules for the Statute Governing Foreign Financial Institutions. 4. In 1996, China allowed Renminbi under current account to be freely convertible. 5. In 1996, China permitted foreign banks in Pudong District in Shanghai to operate Renminbi transactions to a limited extent. 6. In 1998, China permitted certain foreign banks in Shenzhen to conduct Renminbi transactions. 7. In 2001, China completed its written application for WTO accession in September and became an official member since December 11. 8. In 2002, China enforced the new version of the Statute for Foreign Financial Institution Administration.

Table 12: China's WTO Commitments in Financial Services Sectors

Sub-sector	China's Commitments
Banking and other financial services	Geographic coverage
	● Foreign currency business: no geographic restrictions since accession.
	● Local currency business: geographic restrictions are phased out as follows. Upon accession, Shanghai, Shenzhen, Tianjin and Dalian; within 1 year after accession, Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan; within 2 years after accession, Jinan, Fuzhou, Chengdu and Chongqing; within 3 years after accession, Kunming, Beijing and Xiamen; within 4 years after accession, Shantou, Ningbo, Shenyang and Xi'an; within 5 years after accession, all geographic restrictions will be removed.
	Clients
	● For foreign currency business, foreign financial institutions were permitted to provide services in China without restriction upon accession.
	● For local currency business, within 2 years after accession, foreign financial institutions were permitted to provide services to Chinese enterprises; within 5 years after accession, foreign financial institutions will be permitted to provide services to Chinese individuals as well. Foreign financial institutions licensed for local currency business in one region of China may service clients in any other region that has been opened for such business.
	Licensing
	● Foreign financial institutions with total assets of more than US$10 billion (at the end of the year prior to filing the application) are eligible to establish a subsidiary of a foreign bank or a foreign financial company in China. Such institutions are also eligible to establish a Chinese-foreign joint venture bank or financial company. Foreign financial institutions with total assets of more than US$20 billion (at the end of the year prior to filing the application) are eligible to establish a branch of a foreign bank in China.
	● Qualifications for foreign financial institutions to engage in local currency business: 3 years business operation in China and a record of positive profits for 2 consecutive years prior to the application.
	Automobile financing
	● Foreign non-bank financial institutions were permitted to provide automobile financial upon accession.
Securities	● Foreign securities institutions may engage directly (without Chinese intermediary) in B-share business.
	● Upon accession, foreign investors were permitted to establish joint ventures to conduct domestic securities investment fund management business. The maximum permitted foreign equity stake was 33 per cent upon accession, and will rise to 49 per cent within 3 years after accession. Within 3 years after accession, foreign securities institutions will be permitted to establish joint ventures, with a maximum equity stake of one third, to engage (without Chinese intermediary) in underwriting all types of shares as well as government and corporate bonds, to engage in trading of B and H-shares and bonds, and to participate in the launching of investment funds.

Insurance	Form of establishment
	● Foreign non-life insurers are permitted to establish as branches, or as joint ventures with 51 per cent ownership.
	● Within 2 years after accession, foreign non-life insurers are permitted to establish wholly-owned subsidiaries.
	● Upon accession, foreign life insurers were permitted 50 per cent ownership in a joint venture with the partner of their choice.
	Geographic coverage
	● Upon accession, foreign life and non-life insurers, and insurance brokers were permitted to provide services in Shanghai, Guangzhou, Dalian, Shenzhen, and Foshan; within 2 years after accession, they are permitted to provide services in: Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan and Tianjin.
	● Within 3 years after accession, there will be no geographic restrictions.
	Business scope
	● Upon accession, foreign non-life insurers were permitted to provide “master policy” insurance/insurance of large-scale commercial risks with no geographic restrictions.
	● Within 2 years after accession, foreign non-life insurers were permitted to provide the full range of non-life insurance services to both foreign and domestic clients.
	● Foreign insurers were permitted to provide individual (not group) insurance to foreigners and Chinese citizens upon accession. Within 3 years after accession, foreign insurers will be permitted to provide health insurance, group insurance and pension/annuities insurance to foreigners and Chinese citizens.
	Licenses
	● Upon accession, licenses can be issued with no economic needs test or quantitative limits on licenses.
	● Qualifications for establishing a foreign owned or invested insurance institution are as follows: - The investor shall be a foreign insurance company with more than 30 years of establishment experience in a WTO member; - It shall have had a representative office for 2 consecutive years in China; - It shall have total assets of more than US$5 billion at the end of the year prior to application, except for insurance brokers. Minimum total assets required for establishing a foreign insurance brokerage are: US$500 million upon accession; US$400 million within 1 year after accession; US$ 300 million within 2 years after accession; and US$200 million within 4 years after accession.
	Reinsurance
	● The current requirement that domestic and foreign insurers must cede 20 per cent of the gross premium that they receive locally to the state-owned China Reinsurance Company will be phased out within 4 years after accession.

Table 13: Total Assets and Total Debts of Financial Institutions in China

As of Dec. 31, 2003

	Total Assets		Total Debts	
	Billion RMB	Share(%)	Billion RMB	Share(%)
Policy banks	2124.7	7.7	2029.1	7.6
Four SOCBs	15194.1	55	14576.2	54.9
Joint-Stock commercial banks	3817.0	13.8	3683.1	13.9
City commercial banks	1462.2	5.3	1412.3	5.3
Rural Commercial	38.5	0.1	38.0	0.1
City Credit Cooperatives	146.8	0.5	146.4	0.6
Rural Credit Cooperatives	2650.9	9.6	2664.6	10
Non-bank Financial Institutionis	910.0	3.3	768.3	2.9
Postal Savings Institutions	898.4	3.3	898.4	3.4
Foreign Financial Institutions	396.9	1.4	357.7	1.3
Total	**27639.5**	**100**	**26574.1**	**100**

Note: Assets and debts refer to consolidated figures including domestic and foreign currency.
Source: Website of China Banking Regulatory Commission

Table 14: Distribution of assets, loans and deposits in China's banking system, 1999

	Assets		Loans		Deposits	
	Billion RMB	Share of banking system total (%)	Billion RMB	Share of banking system total (%)	Billion RMB	Share of banking system total (%)
Big 4 commercial banks	10403	73.2	6249	71.7	7618	83.0
Joint-Stock commercial banks	1456	10.2	704	8.1	1038	11.3
City commercial banks	554	3.9	271	3.1	441	4.8
Foreign banks	263	1.9	180	2.1	43	0.5
Policy banks	1540	10.8	1312	15.1	37	0.4
Total	**14218**	**100.0**	**8718**	**100.0**	**9179**	**100.0**

Note: Assets, deposits and loans refer to consolidated figures including domestic and foreign currency.
Source: The banking industry in China, 2000

Table 15: Share of short-term loans going to the non-state sector

	Financial institutions			State banks	
	1997 (%)	1998 (%)	1999 (%)	1997 (%)	1998 (%)
Town & village enterprises	6.7	6.4	6.6	2.6	2.6
Private enterprises and individuals	0.5	0.5	0.6	0.3	0.3
Foreign joint ventures	2.5	2.9	3.2	2.9	3.3

Note: Figures refer to credits extended directly to the categories. The table does not include the entire non-state sector as credits to urban credit co-operatives and some other types of enterprises are included in official statistics with credits to SOEs in loans to industry or other segments

Source: *Almanac of China's Finance and Banking 1999, PBOC Quarterly Statistical Bulletin*

Table 16: Banks' profitability in mainland and Hong Kong, China, 1999

	Assets	Capital asset ratio	Pre-tax profit	Return on capital	Return on assets
	US$ million	%	US$ million	%	%
Mainland China					
Industrial and Commercial Bank of China	427546	5.13	498	2.3	0.12
Bank of China	350736	4.35	798	5.3	0.23
Agricultural Bank of China	274876	5.91	-43	-0.3	-0.02
China Construction Bank	265845	4.96	890	7.0	0.33
Bank of Communications	72233	4.19	324	11.1	0.45
Everbright Bank of China	20278	5.10	82	9.8	0.40
China Merchants Bank	19866	7.57	184	14.8	0.92
Shanghai Pudong Development Bank	12466	7.53	142	21.2	1.14
Hua Xia Bank	7383	5.20	62	16.4	0.84
Fujian Industrial Bank	5940	6.59	53	13.7	0.89
Hong Kong, China					
HSBC	210770	4.45	3178	32.6	1.51
Bank of East Asia	18703	9.39	208	12.2	1.11
Nanyang Commercial Bank	11047	11.62	86	6.9	-1.78
Wing Lung Bank	7687	8.17	131	22.2	1.71

Source: *The Banker, October 2000*

Chart 3: Shares of bad loans to total loans in China and other countries

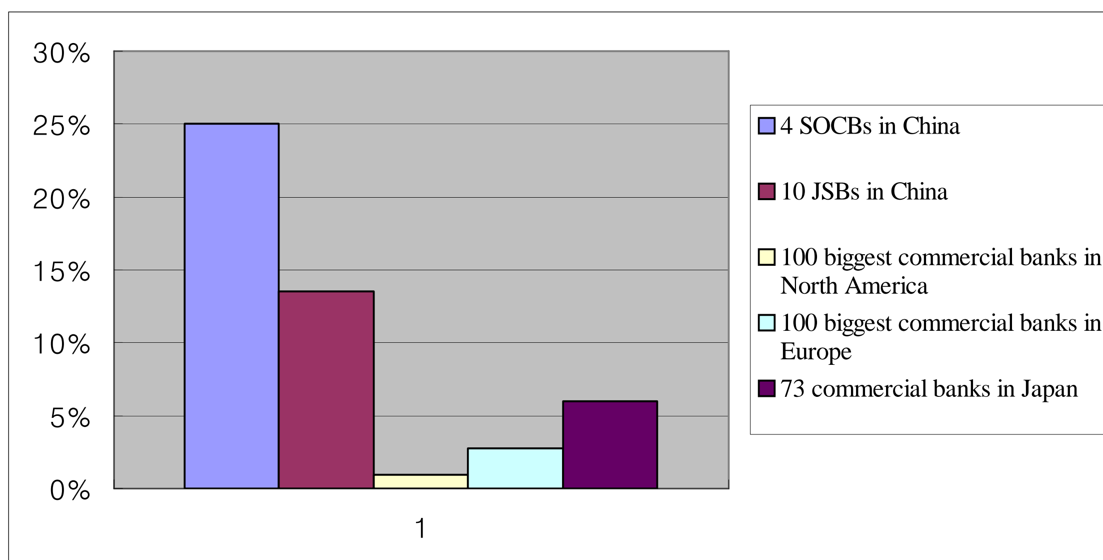


Table 17 Comparison of Banks in China and some OECD Members

	Assets / bank employee: (million US$ / 1000 staff)
China	727
Germany	8651
Japan	16682
Korea	5083
Mexico	1253
Switzerland	12776
Turkey	984
United Kingdom	5126
United States	3451

Source: *China Statistical Yearbook 2000, OECD, Bank Profitability, 2000*

Table 18: Insurance companies licensed on Chinese market

as of June 2001

Life insurance companies	
State-owned enterprises	2
SOE-owned enterprises	8
Joint-venture companies	9
Foreign-owned branches	1
Total	***20***
Non-life insurance companies	
State-owned enterprises	2
SOE-owned enterprises	8
Foreign-owned branches	7
Total	***17***

Source: *OECD (2002)*

Table 19: Three biggest Chinese insurance companies' market share

In 2000

	Gross premium income (US$ bn)	Market share %
Life insurance market		
PICC	5.61	77.63
China Pacific	0.83	11.44
Ping An	0.58	8.07
Others	0.21	2.86
Non-life insurance market		
PICC	7.77	64.5
Ping An	2.71	22.5
China Pacific	1.02	8.5
Others	0.55	4.5

Source: *China Insurance Regulatory Commission*