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# Financial Liberalization in China

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〈CONTENTS〉



## 1. Introduction

Most of emerging countries suffered from severe financial crises after their liberalization in their financial sector as evidenced by the cases of Mexico, Thailand and Korea in 1990s. Even developed countries such as Japan, United States and several countries in European Union have suffered from the crisis in 2000s. For the past 30 years, however, China achieved remarkable economic success with an average annual GDP growth rate of more than 10 percent and finally became the 2nd largest economy in the world.[1)]

Throughout the past three decades of rapid growth, China has made substantial structural transformations in its economy such as industrialization, urbanization and integration into the world

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1) See Yoon (2010), p.56.

economy. China, which had secluded its economy from the outside world for most of the last century, reluctantly started to liberalize and open its financial market during the economic reform process.

As was in the case with Korea and Japan, China's rapid economic growth has been achieved through tight state controls on the financial system for the effective allocation of the scarce resources. Nonetheless, a substantial reform measures in financial sector have taken place since implementation of the economic reform policy in 1978

Financial liberalization in China was initially promoted to encourage foreign direct investment (FDI) flows to supplement limited capital. Later, on the condition that China join the World Trade Organization (WTO) in December 2001, it committed to fully opening up its banking sector to foreign firms by December 2006.

This paper examines the economic theory behind financial liberalization and discusses the process of China's financial reform and liberalization and its effect. The next chapter reviews financial liberalization theory in the literature. The third chapter describes the process of financial liberalization implemented in China while the fourth chapter assesses the liberalization and discusses lessons to be learned. The fifth chapter summarizes and concludes the paper.

## 2. Financial Liberalization Theory

Before examining the Chinese financial liberalization, this chapter reviews the existing studies on financial liberalization. The body of the literature in this area has grown significantly since the 1970s, when the wave of financial liberalization was sweeping the world.

Arestis and Demetriades (1999) argued that the liberalization process has negative impacts on output and promotes financial instability. Arestis, Nissanke and Stein (2003) maintained that financial liberalization policy is built on shaky theoretical premises. Economists called structuralists are strongly against the financial liberalization, pointing out that the financial liberalization always induces a vicious cycle of stagflation. They argue that the availability of loanable funds will decrease with the high interest rates after the liberalization program and thus economic growth will be retarded (Taylor, 1991).

So-called New-Keynesians recognized the problem of asymmetric information inherent in the financial market and the essential role of the government regulation (Hellman, Murdock and Stiglitz, 1998). Stiglitz and Uy (1996) argued that the government-directed allocation of financial could induce higher economic growth in developing countries. Specifically, Stiglitz (1994) advocates government intervention to keep interest rates below their market-equilibrium levels. Moreover, the mild government repression called 'financial restraint' on interest rates and entry of financial institutions can produce rent to help stabilize the financial system (Stiglitz and Uy, 1996).

However, this rent-seeking behavior has been linked to deep-seated corruption, bribery and concentration of economic power, prevalent in developing countries. Financial liberalization theory has its origins in the work of McKinnon (1973) and Shaw (1973) although many scholars previously published the work on the relationship between financial development and economic growth (Schumpeter,1936; Gurley and Shaw, 1955; Gurley and Shaw, 1956; Patrick, 1966; Gurley and Shaw, 1967; and Goldsmith, 1969).

Until the early 1970s, most economists believed that low interest rates would promote investment and economic growth in accordance with Keynesian and neoclassical theories. McKinnon (1973) and Shaw (1973) were the first to challenge seriously this conventional wisdom. They argue that financial repression, which consists of interest rate ceilings, high reserve requirements and direct credit policies, should reduce domestic investment and its productivity, and therefore, financial liberalization can foster economic growth. Their argument, which has recently been supported by a group of economists called the McKinnon-Shaw school, has provided a theoretical ground for the recent movements toward financial liberalization in a large number of developing countries.

McKinnon (1988) pointed out the importance of macroeconomic stability as a condition for the successful outcome of financial liberalization. Fry (1988, and 1995) also focused on the necessity of stable macroeconomic policy but added a sound regulatory framework as one of the preconditions for successful financial liberalization. Later, McKinnon (1991) added that a certain sequence of economic reform should be followed if financial liberalization is to be successful, such as appropriate macroeconomic policy, the liberalization of domestic financing markets and the liberalization of foreign exchanges.

In the early 1990s, the new insight into the operation of financial markets led to a new debate on the financial liberalization with the focus from government to market failure (for example, Villanueva and Mirakhor, 1990; Akyuz, 1993; Demirguc-Kunt and Detragiache, 1998; and Drees and Pazarbasioglu, 1998). According to these views, developing countries do not have the institutions necessary for free-market policies. Demirguc-Kunt and Detragiache (1998) claimed in a study of 53 countries during 1980~95 that financial liberalization increases the probability of a banking crisis but less so where the institutional environment is strong. In particular, they argued that respect for the rule of law, a low level of corruption, and good contract enforcement are relevant institutional characteristics.

## 3. Financial Liberalization in China

Financial liberalization in China has been implemented in a very slow and reluctant manner due to the weaker competitiveness of domestic financial institutions in comparison with international counterparts. However, a substantial progress of Chinese financial liberalization occurred for the purpose of the WTO entry in 2001 after a long period of negotiations with developed nations. This chapter examines financial liberalization process by the four stages.

### 3.1 Stage One Financial Liberalization (1978~91)

Financial liberalization in China started in 1980 when the Special Economic Zones (SEZs) were created in four southern coastal cities to promote foreign direct investment. Foreign financial companies in the zones were allowed to be established only in the form of joint ventures with local firms and were to conduct non-RMB business (lending and deposits) to foreign customers in the SEZs. In 1984, the SEZs were expanded to 14 coastal cities. In 1990, foreign banks were allowed for the first time to do business in non-SEZ coastal cities. Financial liberalization in this stage reflected the Chinese government's attempts to induce the foreign capital in the form of FDI for the country's economic reconstruction (Schlichting 2008, 42).

Amid the overall lukewarm reform measures in financial sector, securities business developed rapidly in the early 1990s. Official activation of the two national stock exchanges, the Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE), took place in 1990 and 1991, respectively. Alongside the Hong Kong Stock Exchange (HKSE), the country has three stock exchanges.

### 3.2 Stage Two Financial Liberalization in (1992~97)

As part of economic reform of the country, financial liberalization gained momentum from 1992 onward. Chinese banks began to compete with each other while foreign banks were opening branches more actively. During this period, foreign banks were allowed to establish branches outside SEZs, firstly in Shanghai and seven open coastal cities, and later in inland cities. Foreign-invested insurance companies were created in 1992 and overseas listing of Chinese shares were allowed in 1993.

In 1996, four foreign banks for the first time started to conduct RMB-business in Pudong on a experimental basis, introducing competition with domestic banks in their core RMB-denominated business. Chinese overseas bond issues sharply increased compared with previous years from U$200 million per year in 1989-91 to over U$2 billion per year in 1992~4 (Schlichting 2008, 42).

Financial liberalization, during the period from 1992 to 1997, was implemented in a more extensive but limited way. Especially foreign financial companies was not given the opportunity to play fair with their domestic counterparts in the RMB-business sector as lots of restrictions were imposed on the foreign banks' business and the speed of business expansion.

### 3.3 Stage Three Financial Liberalization (1998~2006)

Financial liberalization in China gained speed in the wake of outbreak of the Asian financial crisis, which occurred in 1997-8 and swept almost all the East Asian countries but China. Although China did not suffer from the worst impact of the crisis by tight capital controls, the crisis led to a reassessment of financial market risks by the Chinese government. The Asian financial crisis exposed the risks inherent in financial liberalization and highlighted the volatility of portfolio investment under liberalized capital account as foreign borrowings with currency and maturity mismatches eventually triggered the financial crisis in the countries which had previously experienced financial liberalization. On the other hand, the crisis also highlighted the dangers of the domestic banking system fragility, poorer competitiveness of Chinese financial institutions vis a vis their international counterparts and the problems of Chinese banks (Overholt, 2004). This perception lent a fresh impetus to financial reform and financial market has gradually opened. By 1999, foreign banks had been established in 23 cities with the number of foreign banks engaging in RMB-business growing rapidly.

Following the 1997 Asian financial crisis, foreign banks changed their business focus from bank loans to retail banking. Rapid growth in insurance business led to the development of the securities markets. In 2000, there were 154 foreign bank branches, 23 foreign-funded/joint-venture banks and finance companies in China, with their market share just 1.3 percent of all outstanding loans (Schlichting 2008, 46). According to the agreement on WTO entry in 2001, China was scheduled to open its banking, insurance and capital market and get rid of barriers to foreign financial institutions by 2006.

In 2003 the China Banking Regulatory Commission (CBRC) has been created for supervision of the Chinese banking sector to form a financial regulatory system, in which CBRC, China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC) work in coordination, each body having its own clearly defined responsibilities.

Foreign banks have expanded their China-related business scope. In November 2003, the CBRC started to implement new policies, e.g., permitting foreign banks to provide RMB services to all kinds of Chinese enterprises in areas with open RMB business (previously, these banks' RMB services were restricted to foreign-funded enterprises, foreigners and people from Hong Kong, Macao and Taiwan in cities with open RMB business). The new policy also encourages qualified international strategic investors to join the restructuring and reforming of China's banking and financial institutions on a voluntary and commercial basis.

Following the listings of Bank of Communications (BOCOM) and Construction China Bank (CCB) in 2005, Bank of China (BOC) and Industrial & Commercial Bank of China (ICBC) were listed in domestic and international capital markets in 2006 (Yoon, 2011). The BOC launched its IPOs on Hong Kong and Shanghai stock exchanges on June 1 and July 5 respectively, thus becoming the first commercial bank in China to achieve dual listings in both the domestic and international markets. Measured by market capitalization at the end of 2006, the ICBC, the BOC and the CCB were ranked as third, sixth and seventh in the world, respectively (CBRC, 2006).

Reform in financial sector during this stage was implemented more intensively in contrast to the previous years of reluctant, gradual and slow financial liberalization. At the end of 2006, when the period for implementation of China's WTO commitments ended, 74 foreign banks were operating in China with 200 branch offices and 74 sub-branches, as well as 186 foreign banks with 242 representative offices. The number of products permitted to foreign banks exceeded 100 and 115 foreign banks had gained a RMB licence. The foreign-funded banks controlled RMB927.9 billion in assets, accounting for 2.11 percent of all banking assets in China (CBRC, 2006).

### 3.4 Stage four Financial Liberalization (2007~ )

Further reform and opening up of Chinese financial sector has been accelerated after 2006. The Chinese banking institutions continued to introduce foreign capital for the purpose of learning the foreign expertise, systems and best practices. Partnership with foreign institutional investors has helped Chinese banking institutions to bolster their corporate governance, operational management, risk controls, business performance and product innovation. More importantly, the participation of foreign investors has promoted the reform of China's banking sector.

Progress has been further made to transform the China Development Bank (CDB) from a policy bank to a commercial bank with two other the Agricultural Development Bank of China (ADBC) and the Export-Import Bank of China remaining as policy banks.

Following the listings, four large state-owned commercial banks (SOCBs) continued to enhance corporate governance and pursued business transformation and internal reform. The capital adequacy ratios (CAR) of ICBC, BOC, CCB and BOCOM at the end of 2010 were 12.27 percent, 12.58 percent, 12.68 percent and 12.36 percent respectively, with their NPL ratios significantly reduced to 1.08 percent, 1.10 percent, 1.14 percent and 1.12 percent respectively.

With the IPOs of the Agricultural Bank of China (ABC) in July 2010, all five large commercial banks have completed their public listings, and thereby transformed from wholly state-owned commercial banks to public banks with a more diversified shareholding structure. Other than five large commercial banks, eight joint stock commercial banks and three city bank were listed by the end of 2010.

In the meantime the steady progress has been made by Chinese banks to go abroad for overseas business expansion. The ICBC, the CCB and the BOCOM was approved to open branches in the cities abroad. In addition, the BOC, the BOCOM and the China Merchants Bank (CMB) obtained approval from Taiwan financial regulatory authority to set up representative offices in Taiwan, making them the first batch of mainland banks allowed to enter Taiwan market. At the end of 2010, the five large commercial banks set up 89 branches and subsidiaries outside China, acquired or invested in ten foreign banks; six of the national joint stock commercial banks established five branches and five representative offices overseas; and two city commercial banks opened two representative offices overseas. China's banking sector is therefore in a better position to utilize the opportunities and resources in both domestic and overseas markets (CBRC, 2010).

Particularly striking is the increasing presence of foreign financial institutions in the China as the opening-up of the Chinese banking sector. As of the end of 2010, 185 banks from 45 countries and regions set up 216 representative offices in

China, and 37 banks from 14 countries and regions were locally incorporated which maintained 223 branches. In addition, there were two Sino-foreign joint venture banks (maintaining six branches and one subsidiaries), one wholly foreign-owned finance company, and 90 foreign bank branches established by 74 banks from 25 countries and regions (see Table 1). Foreign banks maintained outlets in 45 cities of 27 provinces, 25 cities more than the number at the beginning of 2003.

The total assets of foreign banking institutions in China at the end of 2010 increased 29.13 percent year-on-year to RMB1.74 trillion (see Table 2) with the deposits and loans sharply soaring as much. Foreign banking institutions in China maintained sound performance, with sufficient capital, good asset quality, reasonable profitability and abundant liquidity as their non-performing loan (NPL) ratio registered at 0.53 percent and capital adequacy ratio (CAR) stood at 18.98 percent (CBRC, 2010).

Table 1: Foreign banking establishments in China (As of end 2010)

Unit: Number of banks

| | Foreign banks | Wholly foreign-owned banks | Joint-venture banks | Wholly foreign-owned finance companies | Total |
|---|---|---|---|---|---|
| Locally incoprorated institutions (LII) | | 37 | 2 | 1 | 40 |
| LII branches and subsidiaries | | 223 | 7 | | 230 |
| Foreign bank branches | 90 | | | | 90 |
| Total | 90 | 260 | 9 | 1 | 360 |

Source: CBRC (2010)

Table 2: Foreign bank operations in China (2003-2010)

Unit: Number of banks, RMB 100 million, percent

| Item/Years | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|---|---|---|
| Number of institutions[2)] | 192 | 188 | 207 | 224 | 274 | 311 | 338 | 360 |
| Assets | 3,969 | 5,823 | 7,155 | 9,279 | 12525 | 13448 | 13492 | 17423 |
| Share of total banking assets | 1.50 | 1.84 | 1.91 | 2.11 | 2.38 | 2.16 | 1.71 | 1.85 |

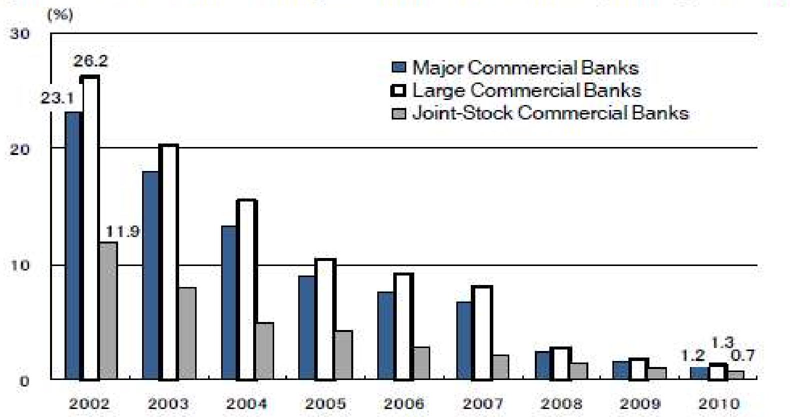
## 4. Evaluation of Chinese Financial Liberalization

Initial financial reform in China was intended to attract foreign funds in the form of FDI. In the mid 2000s the Chinese government focused on the reform in commercial banks and opening-up of China's banking sector as per the commitments for China's entry of WTO in 2001.

The quality of the assets of Chinese banks has significantly improved owing to the government's support in the disposal of NPLs by the large commercial banks (Figure 1). The NPL ratio of the large commercial banks, which account for around 50 percent of the total assets of the Chinese banking sector, decreased to 1.3 percent at the end of 2010 from 26.2 percent at the end of 2002.

2) Including headquarters, branches and subsidiaries. Sources: CBRC (2006~2010)

Figure 1: NPL Ratios of Large Commercial Banks
(at the year-end)

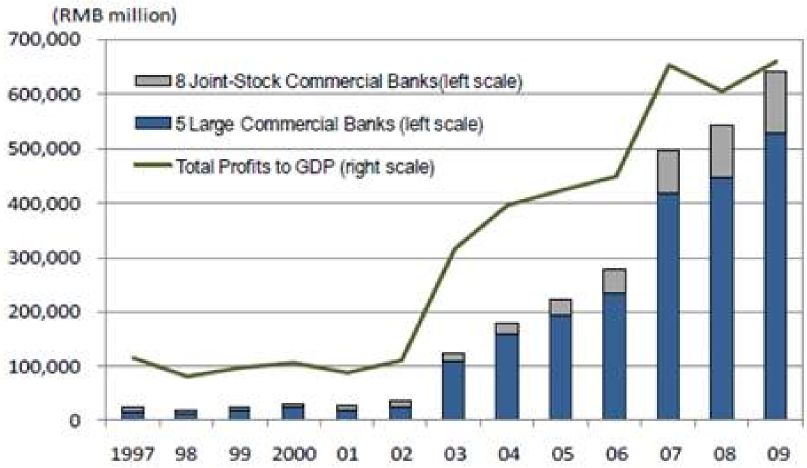



Sources: Bank's annual reports, Recited from Okazaki et al (2011)

The large listed commercial banks enhanced their business performance due to the corporate governance reform (Figure 2). On an average, in 2009, 82 percent of the operating profit of these banks came from the net interest income, and 13 percent from the net fee-based income. These performance was largely a result of the increase of loans with huge interest rate spread of over 3 percent points (see Table 3).

China's reform and opening-up of the banking sector had been focused mainly on FDI inflows. Chinese government has taken cautious stance of removing restrictions on other forms of capital flows, in the conviction that China's tight controls over portfolio flows could prevent speculators from attacking on the Chinese currency at the time of the crisis (Chinn and Ito, 2011). The Chinese authorities began to liberalize other types of cross-border capital flows such as portfolio investments and banking lending in the mid-2000s. Although it has made significant progress toward more open cross-border capital flows in the mid- to late 2000s, China still lags behind developing nations not to mention developed economies.

Figure 2: Pre-tax Profit of Listed Major Commercial Banks



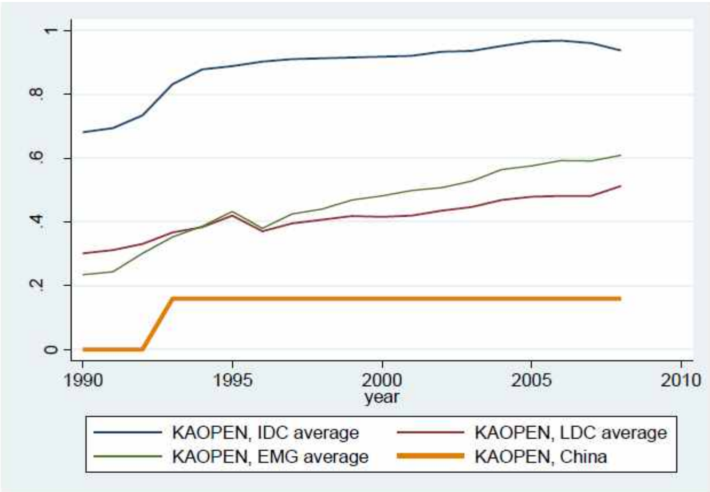

Sources: Bank's annual reports, Recited from Okazaki et al (2011)

Chinn and Ito (2006, 2008, 2011) use the index of capital account openness, or *KAOPEN* to compare cross-country financial openness. *KAOPEN* is based on information regarding restrictions in the IMF''s *Annual Report on Exchange Arrangements and Exchange Restrictions* (*AREAER*).[3] Figure 3 shows that many emerging economies removed or loosened regulatory restrictions on capital flows in the 1990s in terms of

3) There are "*de jure* approach to investigate the extent and intensity of regulatory controls on cross-border capital transactions" and a "*de facto* measure of financial openness. For details, see Chinn and Ito (2006, 2008, 2011).

*de jure* financial openness, whereas China has not made progress since the early 1990s. Chinese financial openness is far below the average level of industrializing countries, less developed countries and emerging market countries.

Figure 3: De jure financial openness (KAOPEN)




Sources: Chinn and Ito (2008) and updated by Chinn and Ito 2011)

Figure 4 shows LMF index - measure of *de facto* financial openness that is calculated as the sum of total stocks of external assets and liabilities as a ratio to GDP (Lane and Milesi-Ferretti, 2007). China seems to have been catching up with other developing countries since the mid-2000s. Most of the catch-up is illustrated to be mainly due to a rapid growth in portfolio investment in the equity while FDI and debt equity investment index are still below both less developed countries' average and emerging market countries' average.

Figure 4: De facto financial openness (LMF index)


Sources: Lane and Milesi-Ferretti (2007) and updated by Chinn and Ito (2011)

Another *de facto* measure involves a measure of spread between lending and deposit rates. With financial liberalization, banks do not get the rent that was previously protected by the regulations on interest rates. Table 3 compares the spread between the lending and deposit rates in China and Japan in the period following financial liberalization. Interest differentials in China slightly narrowed but still huge in comparison with those in Japan, extrapolating that capital account liberalization in China has not been completed yet.

Table 3: Interest Spread in China, Korea and Japan
(at the year-end)

| Interests | China | | Korea | | Japan | | |
|---|---|---|---|---|---|---|---|
| | 1991 | 2010 | 2000 | 2010 | 1970 | 1985 | 2010 |
| Lending (a) | 8.10 | 5.35 | 9.88 | 5.38 | 6.25 | 5.50 | 1.475 |
| Deposit (b) | 3.24 | 2.25 | 6.92 | 2.93 | 4.00 | 3.50 | 0.441 |
| (a) - (b) | 4.86 | 3.10 | 2.96 | 2.45 | 2.25 | 2.00 | 1.034 |

Sources: BOJ, PBOC (Okazaki et al., 2011) and BOK

## 5. Summary and Conclusion

Chinese economy, the second-biggest in the world, has been growing remarkably with an average annual GDP growth rate of more than 10 percent since its implementation of the first economic reforms in 1978. China's rapid economic growth has been achieved through tight state controls on the financial system for the effective allocation of the scarce resources.

Financial liberalization in China has been implemented in a very slow and reluctant manner due to the weaker competitiveness of domestic financial institutions in comparison with international counterparts. Financial liberalization in China started in 1980 when the Special Economic Zones (SEZs) were created in four southern coastal cities to promote foreign direct investment.

The 1997 Asian financial crisis exposed the risks of financial liberalization and the dangers of the Chinese banking system fragility and weak competitiveness of financial institutions were perceived by the Chinese authorities. Reform in financial sector was implemented more intensively in contrast to the previous years of reluctant, gradual and slow financial liberalization, due to China's commitments to its entry to the WTO in 2001. The Chinese banking institutions continued to introduce foreign capital for the purpose of learning the foreign expertise, systems and best practices. With the successful IPOs through 2005~2010, all five large commercial banks transformed from wholly state-owned commercial banks to public banks with a more diversified shareholding structure.

Presence of foreign financial institutions in the China as the opening-up of the Chinese banking sector was significant with their number of branches and subsidiaries totaling 360 at the end of 2010, but their proportion still remains marginal with just 1.85 percent of all banking sector assets in the country.

Chinese government has taken cautious stance of removing restrictions on capital flows other than FDI for the prevention of contagious speculative attack on the Chinese currency in the event of financial difficulties. Although it has made significant progress toward more open cross-border capital flows in the mid- to late 2000s, China still lags behind developing nations not to mention developed economies. China's FDI and debt equity investment are still below both less developed and emerging market countries' average. Interest differentials in Chinese financial markets between lending and deposit rates are still huge in comparison with those in Korea and Japan, extrapolating that capital account liberalization in China has not been completed yet.

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## <국문초록>

중국의 경제는 1978년의 경제개혁을 실행한 이후 괄목할 만한 성장을 거듭하여 이제 미국에 이어 세계 제2위의 경제대국이 되었다. 그러나 경제규모에 비해 금융 산업의 발달은 미흡하다고 평가되어왔다. 1997년의 아시아금융위기와 2001년 세계무역기구(WTO) 가입을 계기로 금융개혁과 금융개방 등 금융자유화가 상당히 진행되었다. 2010년 말 기준으로 중국공상은행, 중국건설은행 및 중국은행이 세계 10대 은행에 포함되며 중국 금융 산업의 성장을 반영하고 있다.

본 논문은 금융자유화에 관한 이론을 소개하고 중국의 금융자유화과정을 단계적으로 구분하여 체계적으로 기술하고 있다. 금융자유화가 진행정도를 살펴보기 위해 개발도상국 및 신흥시장국가와 비교분석을 하였으며, 그동안 상당한 금융자유화 조치가 이루어졌으나 자본시장부문의 자유화가 미흡함을 보여주고 있다.

**주제어** : 국유상업은행 금융개방 금융위기 금융자유화 세계무역기구

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