LIBERALIZATION OF CHINA'S FINANCIAL MARKET UNDER GATS

by
Jingping Ma

Faculty of Law
McGill University, Montreal
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ABSTRACT

After almost 15 years of effort, China is finally on its way to membership of the WTO. Accordingly, China will liberalize its financial sector that basically consists of banking, insurance and securities industry and it will phase out most of the existing restrictions respecting foreign participation in this sector. However, in a sector with a formidable legacy of substantial non-performing loans, low efficiency, and the moral hazards attendant on a command economy, the future of liberalization in this sector is anything but certainty.

Through reviewing the application of GATS principles on financial services, canvassing the past and present of China's financial sector, analyzing the laws and regulations in respect of foreign participation in China's financial sector and through identifying existing problems, possible solutions for the liberalization of China's financial sector have been presented in detail.

RÉSUMÉ

Après presque 15 ans d'efforts, la Chine est finalement en mesure d'adhérer à L'O.M.C. En conséquence, la Chine va libéraliser son secteur financier qui se compose des banques, des assurances, et des industries des valeurs mobilières et elle va aussi faire disparaitre peu à peu la plupart des restrictions existants concertant la participation étrangère dans ce secteur.

Cependant, dans un secteur où il y a un lourd héritage de prêts non-remboursés, d'inefficacité et de corruption accompagnant l'économie contrôlée, l'avenir de la libéralisation dans ce secteur reste très incertain.

En etudiant l'application de principes du GATS aux servics financiers, et le passé et le présent de ce secteur en Chine, et par analyser des lois et des règlements applicable à la participation étrangère dans le secteur financier de la Chine, et en identifiant les problèmes existants, les solutions possibles pour libéraliser le secteur financier de la Chine sont présentés en détail.

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INTRODUCTION

After almost 15 years of negotiations, China is finally on its way to membership of the WTO. China's accession to the WTO will not only have a great impact on China's economy, but will also have a great effect on the integration of the World economy. In the process of China's WTO accession, the negotiations in respect of liberalization of China's financial sector was one of the hardest "nuts" to crack. The Chinese government has been very cautious in terms of opening up its financial sector. This is because, on the one hand, China's financial sector, which bears all the imprints of a command economy: state monopoly, low efficiency, lack of financial engineering expertise and mountains of non-performing loans; on the other hand, liberalization of the financial sector, which would lead to capital account liberalization, tends to involve a sensitive topic: socialist state ownership. Anyway, after over 20 years of economic reform, many foreign financial institutions have entered China and operated in a variety of forms, albeit with certain geographic and business restrictions.

After the Asia Financial Crisis, China lost its momentum of high gear economic growth for the first time in the last ten years. Meanwhile, the Chinese government increasingly realized not only that foreign investment played a crucial role in China's economic growth but also that the financial sector had become a crucial factor in China's economic development. To attract more foreign investment and to reform its financial sector according to international practices, the Chinese Government became more determined to enter the WTO. After China had made considerable concessions in relation to its financial sector and other key sectors, China reached WTO accession agreements with the US, EU, Canada and other WTO Members. The Chinese government will liberalize its financial sector according to its commitments, which comply with the GATS rules, not later than five years after its accession to the WTO. The Chinese government and Chinese financial institutions must learn to play according to GATS rules so as to carry out efficiently the commitments, while foreign investors must seek to understand the past and present of China's financial sector so as to predict its future.

Herein lies the purpose of this thesis: to give an overview of China's financial sector, to analyze current laws and regulations concerning foreign participation in China's financial sector, to identify existing problems, and recommend possible solutions for the liberalization of China's financial sector under GATS. This thesis is divided into four parts.

Part I generally discusses financial services under GATS. Just as GATT aims to establish rules to liberalize world trade in goods, GATS seeks to establish rules to liberalize world trade in services. However, unlike GATT rules, which have been in effect over several decades, many GATS rules in terms of their application still need further characterization, clarification and demarcation. This part specifically consists of clarification of definitions of services and trade in financial services, the presentation of the development of financial services under multilateral legal framework, and an evaluation of the role of GATS in the liberalization of financial services. There also is an analysis of the application of basic principles such as MFN, NT, and Market Access regarding trade in financial services.

Part II deals with the liberalization of China's financial sector. Firstly, an overview of China's financial market structure is presented both from an institutional perspective and a market perspective. Relevant laws and regulations are analyzed. Secondly, foreign participation before China's accession to the WTO, including types of participation and relevant laws and regulations are also discussed. Thirdly, foreign participation after China's access to WTO is discussed in relation to China's commitments in the China-US and China-EU WTO accession bilateral agreements.

Part III identifies the existing problems in China's financial market and formulates lessons that China could learn from the Asia Financial Crisis. Recommendations for China's financial liberalization under GATS are also put forward. More specifically, topics such as universal banking, capital account liberalization, anti-trusts in financial sector are discussed in greater detail.

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PART ONE: FINANCIAL SERVICES UNDER GATS

I. INTRODUCTION TO TRADE IN SERVICES AND TO THE SPECIAL PROBLEMS OF TRADE IN FINANCIAL SERVICES

A. Trade in Services

A pronounced tendency in contemporary economic development is that service industries are growing at an accelerating speed and are attracting more and more direct foreign investment. Services are the largest recipients of international investment flows, accounting for just over half of all global outflows in 1999 and they comprised about one-fifth of world-wide trade in forms of the balance of payments.[1] In terms of the overall contribution to total employment, in the US they accounted for 78%; in the UK, France and Japan, they accounted for about 60-70% and in Hong Kong they even reached up to 82% in 1999.[2] Little wonder, therefore, that one economist has defined our society as the "Service Society" where manufacturing industries only have a supportive function and services now determine economic growth.[3]

Notwithstanding the growing importance of services in the global economy, generally acceptable definitions of services, and trade in services, are still lacking. In his book *Service-Led Growth: The Role of the Service Sector in World Development*, published in1986, Riddle, D., an American economist, pointed out the importance of trade in services in promoting global trade and in optimizing the economic structure. Consequently, he undermined to a certain degree the commonly

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[1] UNCTAD, *World Investment Report* (New York: UNCTAD, 2000) at 168.
[2] OECD, *Statistics on Value Added and Employment* (Paris: OECD, 2001) at 32,33.
[3] Sven. Illeris, *The Service Economy* (New York: John Wiley & Sons Co., 1996) at 179,193.

held theory advanced by Adam Smith that services are unproductive of any value. However, even today, many economic textbooks still state the definitions concerning services quite differently."[4] This reflects the widely perceived complexity of services, primarily due to their intangible nature and the necessity for further studies in this field.

B. Definition and Characteristics of Services and Trade in Services

In a paradoxical way, the more intensively services are studied, the less certainty there is about how they can be defined and classified.[5] Most definitions attempt to convey the essence of services by identifying how they differ from goods but they consequently fail to explain the purpose of defining services as something inherently different from goods. An adequate definition must, *inter alia,* distinguish the process of the production from the product of a service. In attempting to differentiate the performance and effects of services, Hill has defined services as "a change in the condition of a person or a good belonging to some other economic unit, which is brought about as the result of the activity of some other economic unit, with the prior agreement of the former person or economic unit."[6] However, Nicolaides points out that because Hill fails to clarify the term "change" he might therefore find it difficult to justify his definition when services such as insurance or

[4] See generally P.R. Krugman and Maurice Obstfeld, *International Economics: Theory and Policy* (Readings, Massachusetts: Addison-Wesley, 1997).
[5] Under GATT there was a services classification list known as 1991 GATT GNS/W/120 Services Sectoral Classification List which contained 12 major categories of services, namely, business services; communication services; construction and related engineering services; distribution services; educational services; environmental services; financial services; health related services; tourism and travel related services; recreational, cultural and sporting services; transport services and other services not included elsewhere. However, this list functioned more as a negotiating list rather than as a statistical classification.

professional services are involved.[7] Nicolaides prefers the definition by Riddle stating that "services are economic activities that provide time, place and form utility while bringing about a change in or for the recipient of the service. Services are produced by (a) the producer acting for the recipient; (b) the recipient providing part of the labor; and/or (c) the recipient and the producer creating the service in interaction." He also points out that Riddle's definition was considerably more comprehensive and accounts for the time element in the intended or expected effects.[8] The 1993 System of National Accounts (SNA) defines services as follows: "Services are not separate entities over which ownership rights can be established. They can not be traded separately from their production. Services are heterogeneous outputs produced to order and typically consist of changes in the condition of the consuming units realized by the activities of the producers at the demand of the customers. By the time their production is completed they must have been provided to the consumers."[9]

The main distinguishing features of trade in services are as follows: first, it often involves a different "mode of supply" than trade in goods. Indeed, Bhagwati and Sampson and Snape [10]were the first to point out that services fall into two categories: those which require physical proximity between consumers and

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[6] T.P. Hill, "On Goods and Services" (1977) 23:4 The Review of Income and Wealth 315 at 317.
[7] Phedon Nicolaides, *Liberalizing Service Trade* (London: Routledge, 1989) at 9.
[8] *Ibid.* at 8-9.
[9] OECD, *Manual on Statistics of International Trade in Services*, online: OECD <http://www.oecd.org/std/TIS-Dec2000_meeting/DOCS/SERV200-2e.pdf> (date accessed 03/04/2001).
[10] See Bhagwati, Jagdish, "Splintering and disembodiment of services and Developing Nations" (1984) 7:2 The World Economy 133 at135-139; see aslo Sampson, Gary and Richard Snape, "Identifying the issues in trade services" (1985) 8:2 The World Economy 171 at 181-182.

suppliers and those which do not. In the latter instance, trade in services is akin to trade in goods. By contrast, in the former case, trade in services involves the international movement of either consumers or suppliers; second, information about the characteristics of the services in question at the time of purchase is usually imperfect; third, despite the ongoing movement towards deregulation, service markets often remain highly regulated.

The term services covers so heterogeneous a range of intangible products and activities that any attempt to encapsulate them within a simple definition would seem to present an insurmountable task. The General Agreement on Trade in Services (GATS),[11] the first ever set of multilateral, legally-enforceable rules, which governs multilateral trading in services, all services sectors and all measures affecting such trade, does not give a definition of services, but rather defines trade in services in terms of the following four modes:[12]

- cross-border trade (e.g. exporting software in a floppy disc format, sending business reports and computer to computer transfer);
- consumption abroad (the movement of consumers from one country to another to avail themselves of foreign services, e.g. medical services);
- commercial presence (setting up an establishment in a foreign country);
- presence by natural persons (movement of service providers from one country to another, as in the case of lawyers travelling abroad to provide legal services).

[11] *General Agreement on Trade in Services*, 15/04/1994 done at Marrakesh, 33 I.L.M.1167 (entered into force 01/01/1995), online: WTO <http://www.wto.org.english/tratop_e/1-scdef_e.htm>(date accessed 03/11/2000)[hereinafter GATS].
[12] *Ibid.* Art. I(2).

The definition of trade in services is, therefore, much broader than the traditional concept of trade used in the context of goods, which only entails cross-border transactions. It even goes beyond the notion of transactions between residents and non-residents used to define the current account of the balance-of-payments, which excludes dealings requiring the establishment of a "commercial presence" by a foreign supplier.

C. The Role and Growing Significance of Trade in Financial Services

"Financial services are produced by financial services firms, also called financial institutions or financial intermediaries."[13] Like other services, financial services embody an element of physical production. Machines and personnel must be combined in physical locations and integrated into a production process. However, the production of financial services embodies a mental process, which is usually more important today than the physical production facility. Financial services are heavily regulated by government authorities in terms of legal entry into business, the products they may offer, and the locations they may serve. Regulation occurs due to a desire to protect financial customers from financial losses resulting from the failure of the financial firms, particularly the depository financial institutions. The failure of a bank affects more people in a society than the failure of a manufacturing firm. This is especially true when the households' savings are concentrated in a few big banks of a given country. Regulation also derives from the desire to control the volatility and riskiness of the financial markets.

[13] William L. Scott, *Markets and Institutions – A Contemporary Introduction to Financial Services* (Cincinnati: South-Western College Publishing, 1999) at 4

Financial services covered by GATS include two broad categories of services:[14]

- Insurance and insurance related services: life and non-life insurance, reinsurance, insurance intermediation such as brokerage and agency services, and service auxiliaries to insurance such as consultancy and actuarial services;
- Banking and other financial services: all traditional services provided by banks such as acceptance of deposits, lending of all types, and payment and money transmission services. Other financial services include trading in foreign exchange, derivatives and all kinds of securities, securities underwriting, money broking, asset management, settlement and clearing services, provision and transfer of financial information, and advisory and other auxiliary financial services.

Despite the starkly opposite opinions existing among economists with regard to the significance of financial services in an economy, [15] a growing body of empirical analyses demonstrates a strong positive link between the expansion of financial services and long term economic growth.[16] All branches of economic activity today are fundamentally dependent on access to financial services. It is hard to imagine

[14] See *Annex on Financial Services*, A financial service is defined as any service of a financial nature offered by a financial service supplier of a Member; a financial service supplier means any natural or judicial person of a Member wishing to supply or supplying financial services but the term "financial service supplier" does not include a public entity. Online: WTO <http://www.wto.org/english/tratop_e/serv_e/10-anfin_e.htm> (date accessed: 03/112000).

[15] Walter Bagehot and John Hicks attached great importance to financial service, on the other hand Joan Robinson , Robert Lucas and Nicholas Stern are of opinion that financial services play a secondary role. See Dilip K. Das, "Trade in Financial Services and the Role of the GATS-Against the Backdrop of the Asian Financial Crisis" (1998) 32:6 Journal of World Trade 79 at 83.

[16] See Levine, "Financial Development and Economic Growth: Views and Agenda" (1997) 6 Journal of Economic Literature 688 at 688-726

any form of economic activity, except perhaps with regard to the least developed countries, that does not depend significantly on services provided by the financial sector. In fact, it is the diversified intermediation and risk management services provided by the financial system that have made possible the development of modern economies. Contemporary global economic integration basically includes trade liberalization, finance globalization and manufacturing integration. Trade in financial services essentially reflects the conjunction of each of these three aspects. With the accelerated development of transnational corporations and global economic integration, trade in financial services has reinforced its function in global economic growth as an "adhesive" and "catalyst" and has become a crucial sector for global economic growth.

Financial services constitute a large and growing sector both in developed and developing countries. Thanks to the conjunction of new and growing markets in developing and transition economies, financial and trade liberalization, the uses of new financial instruments and rapid technology change, trade in financial services is growing at a rapid rate.

To illustrate the importance of the financial service sector, we can examine at the share of financial services in total employment and the total gross value added in certain developed countries. In conjunction with real estate services, financial services contributed 12.7%, 16.5%, 18.5%, 15.4% and 13.9% to total employment, respectively, in Canada, United Kingdom, the United States, France and Germany in 1999.[17] Together with real estate services, financial services contributed respectively 22.1%, 30.1%, 31.4%, 28.3% and 29.3% to the total gross value added of Canada, France, Germany, UK and the US.[18]

The size of the banking sector can also illustrate the vital role of the financial services sector in national economies. Total banking assets in Japan, the European Union and the United States amounts to around US$ 10 trillion each in 1994. The banking assets of some developing countries such as Thailand, Mexico and Brazil range from US$ 100 billion to US$ 1 trillion.[19]

Compared with the growth of domestic markets, the growth of international financial activities has been even more rapid in the past ten years. The value of securities issues reached US$ 1234.6 billion in 2000. The turnover of futures and options in 2000 were, respectively, US$ 317,442.6 Billion and US$ 66,330.3 Billion.[20]

No doubt, industrial countries still play a dominant role in the international financial market. However, according to statistics from BIS (2001), developing countries have made some progress in integrating themselves into this market.[21]

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[17]OECD, *supra* note 2 at 32, 33.
[18] OECD, *supra* note 2 at 30, 31.
[19] "Top 150 Banks Worldwide by Size of Assets", online: CBA Statistics <http://www.cba.ca/eng/Statistics/Stats/bankings.htm> (date accessed: 06/12/2000).
[20] BIS, *Securities Statistics* at table 11, table 23A, online: Bank for International Settlements <http://www.bis.org/statistics/secstats.htm> (date accessed: 09/06/2001).
[21] *Ibid.*

II.TRADE IN FINANCIAL SERVICES UNDER THE MULTILATERAL FRAME WORK

A. Progress in Financial Services Negotiations

During the nineteen - seventies the United States government increasingly realized the importance of trade in services for its economic growth since its great deficit in trade in goods was largely made up from the surplus of trade in services. In the export sectors, financial services played a key role. While realizing the importance of financial services to the national economy, the US government also found it was very difficult for its financial service suppliers to penetrate into foreign financial markets. Under those circumstances, the US government began to consider establishing multilateral trade rules for services. During the 1982 GATT Ministerial Conference, the US trade representative raised the subject of the reduction of non-tariff barriers in trade in services. Except for the United Kingdom, no other countries supported this proposal. At that time, the EEC did not yet see itself as a super service exporter and hence, a beneficiary of such rules. Consequently, the EEC did not show any interest in the proposal. Eventually, these initial efforts by the US led to the inclusion of trade in services on the agenda of the Uruguay Round launched in Punta del Este in 1986.[22] The developing countries started the negotiation with reluctance because as a group they did not see themselves as possessing much of a comparative advantage in the production and exchange of services. Fearing the loss of certain benefits obtained under GATT, the developing countries firmly opposed the incorporation of services into GATT. As a result, negotiation for trade in services took another track.[23]

At the end of the Uruguay Round negotiations in 1993, negotiations on financial services, along with those on basic telecommunications and maritime transport, remained incomplete. Although 82 governments made offers to open their markets to financial service providers, these offers were not considered sufficient to conclude an agreement. The Second Annex on Financial Services to GATS and the Decision on Financial Services adopted at the end of the Round allowed an extended period of six-month following the entry into force of GATS for negotiations in this sector. During this period, members of the WTO were permitted to improve, modify or withdraw all or part of their commitments. They were also able to introduce additional MFN exemptions.[24]

The 1995 negotiations were actually concluded on 28 July,1995 rather than 30 June that year as originally planned. The agreement was called the "interim" agreement, as negotiators again decided that the results of the negotiations were not satisfactory and envisaged further negotiations in a 2 year period. Through the 1995 negotiations, 43 WTO Members improved their schedules of specific commitments and some of them removed, suspended or reduced the scope of their FMN exemptions in financial services. These improved commitments constituted part of

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[22] WTO, "GATS – Financial Services", online: WTO <http://www.wto.org/english/thewto_e/whatis_e/eolle/wto6/wto6_33htm> (date accessed: 06/12/2000).
[23] Pierre Sauve, "Developing Countries and the GATS 2000 Round" (2000) 34:2 Journal of World Trade 85 at 85.
[24] WTO, *supra* note 22.

the *Second Protocol to the GATS.* Three other countries (Colombia, Mauritius and the United States) had yet to improve their commitments, and took broad MFN exemptions based on reciprocity. As a result of these extended negotiations, and with new accessions to the WTO, 97 Members of the WTO had commitments in financial services, compared to some 76 countries at the end of the Round. The Second Protocol and the commitments annexed thereto entered into force at the beginning of September 1996, with the exception of a few countries that were unable to complete their internal ratification procedures and formally accept the protocol before July 1996. For those remaining countries, the commitments entered into force 30 days after acceptance.[25]The negotiations were reopened in April 1997. Members again had an opportunity to improve, modify or withdraw their commitments in financial services and to take MFN exemptions in the sector from 1 November to 12 December 1997. Consequently, a new and improved set of commitments in financial services under the GATS was agreed upon on 12 December 1997. A total of 56 schedules of commitments, with the EU representing 15 countries, and a list of the MFN exemptions, were submitted by the time of the negotiating deadline and annexed to the *Fifth Protocol to the GATS*, which was open for ratification and acceptance by Members until 29 January 1999. Fifty-two Member governments accepted the protocol by the agreed due date. The Council for Trade in Services also decided that the protocol would be kept open for acceptance till 15 June, 1999 for the remaining 18 members.[26]

[25] G. McGillivray, "International Trade Body Turns to Financial Services Competition" (1999) 8 Canadian Underwriter 66, at 36-42.

[26] WTO, "The Results of the Negotiation of the Financial Service Under GATS" (1998), online: WTO <http://www.wto.org/english/news98_e/finsum.htm> (date accessed: 01/02/2001).

With five countries – Bolivia, Costa Rica, Mauritius, Senegal, and Sri Lanka making commitments in financial services for the first time in 1999, the total number of WTO members with commitments in financial services under GATS reached 104. Governments representing more than 90% of the global financial services market agreed in February 1999 that the landmark financial service agreement would enter into force on 1 March, 1999. However, an extension for acceptance of the protocol until June 15, 1999 was later accepted by the Council for Trade in Services.[27]

B. Analysis of Some Documents concerning Financial Services Annexed to GATS

i) Understanding on Commitments in Financial Services

The 18 months extension provided in the Second Annex and confirmed by the Ministers' Decision on Financial Services made it procedurally possible to continue the negotiation on financial services. However, not all Uruguay Round Participants were willing to participate in such extended negotiations for a variety of reasons. As a result of compromise, an Understanding on Commitments in Financial Services[28] was reached. This *Understanding*, which was based on the proposals submitted by the United States and the EC with joint proposals by Canada, Japan, Sweden, and Switzerland, and certain opinions from developing countries, reflected the desire of OECD countries to establish a procedure for making further commitments

[27] *Ibid.*
[28] *Understanding on Commitments in Financial Services,* WTO Doc, online: WTO <http://www.wto.org/english/tratop_e/serv_e/21-fin.htm> (date accessed: 03/02/2001)[hereinafter *the Understanding*]

respecting financial services in accordance with guidelines intended to ensure a minimum level of liberalization and a certain degree of uniformity.[29]

Concerted efforts from the developing countries prevented the Understanding being separated from the overall agreement in services and becoming a self-contained financial service agreement. This is clearly reflected in the first paragraph of the Understanding:[30]

- it does not conflict with the provisions of the GATS;
- it does not prejudice the right of any Member to schedule its specific commitments in accordance with the approach under Part III of the GATS;
- resulting specific commitments shall apply on MFN basis;
- no presumption has been created as to the degree of liberalization to which a Member is committing itself under the GATS.

Thus, commitments undertaken on the basis of *the Understanding* would apply to all Members of the WTO in accordance with the unconditional MFN principle. Members not making commitments under *the Understanding* would nevertheless benefit from a greater liberalization of financial services by those countries agreeing to do so. Compared with Part III of GATS, *the Understanding* contains more onerous liberalization obligations, more specific provisions on market access and an explicit standstill obligation. Article 7 of the Understanding together with the definition thereof clearly shows that they are in the interests of developed countries

[29] Yi Wang, "Most-Favored-Nation Treatment under the General Agreement on Trade in Services – and its Application in Financial Services" (1997) 31:1 Journal of World Trade 91 at 110-113.
[30] *Supra* note 28 at paragraph one.

as new financial services are mainly derived from developed countries.[31]

ii) The Second Protocol to the GATS[32]

After the conclusion of the Understanding, the OECD countries and 20 developing countries consequently improved their commitments. However, at the fifth meeting of the Committee on Trade in Financial Services on 29 June, 1995, the United States announced a surprise decision on two actions: one was to maintain the offer that had protected the existing activities of foreign financial service providers in the United States; the other was not to be bound to open the US market or to guarantee national treatment for new entrants and new activities. Spurred by the sudden action of the US, other participants tried to look for ways to maintain and improve the offers on the table. The Council for Trade in Services adopted the proposal of the EC to extend the deadline from 30 June to 28 July,1995. Due to the efforts of the members concerned in the last four weeks, they concluded the *Second Protocol to GATS* and the *Schedules of Specific Commitments and the List of Exemptions* from Article II of GATS annexed thereto, which was hailed by Mr. R. Ruggiero as "a very good second best." According to Paragraph I of the Second Protocol, the Schedules and Exemptions annexed thereto shall replace the corresponding sections of the original Schedules upon the entry into force of this Protocol for the Members

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[31] Art. 7, A member shall permit financial service suppliers of any other Member established in its territory to offer in its territory any new financial service.
Definition of new financial services: a new financial service is a service of a financial nature, including services related to existing and new products or the manner in which a product is delivered, that is not supplied by any financial service supplier in the territory of a particular Member but which is supplied in the territory of another Member. *Supra* note 28.

[32] *Second Protocol to the General Agreement on Trade in Services* WTO Doc S/L/11(adopted 21/07/1995, entered into force 01/09/1996), online: WTO <http://www.wto.org/english.tratop_e/serv_e/2prote_e.htm> (date accessed: 03/01/2001).

concerned.

Compared with the commitments in the financial services sector in the Uruguay Round, 29 Members had submitted revised Schedules (counting the EC as one) and 13 Members revised MFN exemption lists according to the approach in the *Understanding* and commitments in banking, insurance and other financial services had been improved by the end of July 1995. *The Second Protocol* somewhat realized the purpose of the *Understanding*. The EC committed itself to allow a foreign financial presence on the basis of the unconditional MFN;[33] Japan and Canada, respectively, extended their bilateral (Japan-US Bilateral Financial Service Agreement) and regional (NAFTA) preferential treatment in financial services to other WTO members. Some developing countries somewhat improved their degree of financial market liberalization. The most evident practical changes, for many Members, are likely to be the presence of more foreign banks, securities firms and insurance companies in their financial markets.[34]

The significance of the *Second Protocol* to the global financial services and the world economy lies in the fact that it established the basic framework for trade in financial services and promoted liberalization in this area.

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[33] EU, "EU makes new WTO offers on Financial Services" (1995), online: <http://www.europa.eu.int/comm.internal_market/en/finances/general.587.htm> (date accessed:01/02/2001)

[34] Ying Qian, "Financial Services Liberalization and GATS – Analysis of the Commitments under the GATS"(2000) at 4-16, online: <http://www.1worldbank.org/wbiep/trade/manila/financial_services.pdf> (date accessed:03/02/2001).

iii) *The Fifth Protocol to the GATS*[35]

The Council for Trade in Financial Services made a decision on 21 July 1995 that Members might modify or withdraw all or part of their commitments in the Schedule of Specific Commitments and might add exemptions in the list of MFN Exemptions within 6 months from 1 August 1996. Negotiations reopened in April 1997 and as a result of these negotiations, the United States, India and Thailand decided to withdraw their broad FMN based on reciprocity; only a small number of countries submitted limited MFN exemptions or maintained existing broad MFN exemptions. On 3 December 1997 the Members achieved the *Fifth Protocol* to which 56 schedules (the EC as one) and 16 lists of MFN exemption were annexed.[36]

The new commitments contain *inter alia* significant improvements allowing the commercial presence of foreign financial service suppliers by eliminating or relaxing limitations on foreign ownership of local financial institutions, limitations on the juridical form of commercial presence (branches, subsidiaries, agencies, representative offices, etc.) and limitations on the expansion of existing operations. Important progress was also made in "grandfathering" existing branches and subsidiaries of foreign financial institutions that are wholly or majority-owned by foreigners. Improvements were made in all of the three major financial service sectors – banking, securities and insurance - as well as in other services such as

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[35] *Fifth Protocol to the General Agreement on Trade in Services* WTO Doc S/L/45 (adopted 14/11/1997, entered into force 01/03/1999), online: WTO homepage <http://www.wto.org/english.tratop_e/s_negs_posturuguay_e.htm> (date accessed: 03/02/2001).
[36] *Supra* note 26.

asset management and the provision and transfer of financial information.[37] The result reflects the widespread recognition of the merits of competition and open markets in financial services. Both developed and developing countries want to make themselves attractive to private foreign investment.

III. THE ROLE OF GATS IN LIBERALIZATION OF TRADE IN FINANCIAL SERVICES AND APPLICATION OF MFN, NATIONAL TREATMENT, AND MARKET ACCESS IN TRADE IN FINANCIAL SERVICES

A. Role of GATS in Liberalization of Trade in Financial services

The framework of GATS is composed of: (1) rules and obligations specified in the Articles of the Agreement; (2) annexes on specific sectors and subjects including an annex on financial services; and (3) national schedules of market access and national treatment commitments and lists of MFN exemptions.

However, not all government intervention that could have an impact on the financial service sector falls within the ambit of GATS. Firstly, macroeconomic policy management in general is not within the scope of the GATS. For example, the conduct of open market operations by central banks could affect the financial sector through the impact of such interventions on the money supply, interest rates, or exchange rates; secondly, prudential measures such as capital adequacy ratios and solvency margin requirements, restriction of credit concentration or portfolio

[37] *Supra* note 26.

allocation, and liquidity ratios, are by no means curtailed by GATS.[38] Notwithstanding 2(a), where prudential measures do not conform to other provisions of the GATS, they must not be used as a means of avoiding commitments or obligations under the Agreement.

The GATS focuses on the reduction and elimination of the measures that constitute restrictions aimed at preventing the domestic establishment of foreign service suppliers or the foreign supply of services on a cross-border basis. The rationale of GATS, which is contained in GATS Part IV- Progressive Liberalization - is allowing Members to develop an appropriate flexibility to make commitments in particular sectors so as to achieve progressive liberalization through successive rounds of negotiation to reduce or eliminate over time the adverse effects of government measures on trade in services.

The GATS offers a vehicle for securing progressive liberalization and obtaining the benefits of a more efficient, stable and diversified financial sector in that: firstly, a multilateral commitment has the effect of tying in the degree of liberalization attained under the existing policy regime, or of tying in future liberalization commitments. In both cases, because these are multilateral commitments, national policies become more predictable and certain. Secondly, the possibility of making commitments to future financial service trade liberalization can help to shape and

[38] Paragraph 2(a) of the *Annex on Financial Services* provides that: "Notwithstanding any other provisions of the Agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the

underpin essential macroeconomic and regulatory reforms. For the purpose of avoiding undesirable destabilizing effects, trade liberalization needs to be combined with appropriate domestic macroeconomic policy and adequate regulation. It is in this context that commitments under the GATS to future trade liberalization can make a contribution, by setting a time frame for essential macroeconomic policy and regulatory reforms, and by infusing an additional sense of purpose, coherence and urgency into the reform. Thirdly, commitments under the GATS provide a signal of policy stability and intent to potential foreign investors. Finally, a willingness to make commitments in the context of multilateral negotiations may induce other countries to do the same, through the recognition of mutual benefits.[39]

Policy commitments, which mirror the actual, historical level of liberalization in the market, do not immediately further the declared GATS objective of progressive liberalization. But they do have the advantage of setting a benchmark of actual openness that prevents "policy slippage" and which can serve as a basis for future liberalization.

B. Application of the MFN in Trade in Financial Services

Regarded as one pillar of GATS, the MFN is a very useful instrument universally employed to expand world trade, based on the principles of equality and non-

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financial system". online: <http://www.wto.org/english/tratop_e/serv_e/10_anfin.htm> (date accessed: 02/03/2001).

[39] Masamichi Kono et al., "Opening Markets in Financial Services and the Role of the GATS" (Geneva: World Trade Organization, c1997) at 3-6.

discrimination. Article II (1) of the GATS states that: "with respect of any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member, treatment no less favorable than that it accords to like services and service suppliers of any other country." As it belongs to Part II of the Agreement, the MFN obligation encompasses "any measure" by Members affecting trade in any sector transacted through any of the four principal modes of supply. However, given the heterogeneity of wide-ranging service sectors and the sharp disparity of levels of economic development and the degrees of development of service regulations of the participating states in the Uruguay Round, not all governments were willing to accept such a general obligation. Therefore, Article II (2) permits "self-selective" exemptions and exceptions which could be expressed at the time of initial GATS commitments.[40] The exemption is granted for a period of five years; moreover, it is subject to review by the Council for Trade in Services every five years and should, in principle, not exceed ten years. Thus, the exemptions cannot be of a permanent nature but are to be of a limited duration.[41] The MFN exemption partially reflected the concern of some "large exporters" in financial services regarding "free riders" as they were afraid that by granting unconditional MFN they would lose the opportunity to require reciprocity from their trading partners, especially developing countries where service market access is heavily restricted.[42]

[40] *Supra* note 11, Art.II(2) provides that "a Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in and meets the conditions of the Annex on Article II Exemptions".

Besides the "self-selective" exemptions, there are some universal exemptions under GATS. Some of them are subject to prior approval by notification to the Council for Trade in Financial Services and some are self-executive. Specifically they are as follows:

- according to Art. II, paragraph 3 of the GATS, preferential arrangement in frontier zones for trade in services are not prevented provided that such services are both locally produced and consumed;
- subject to Art.V, more favorable treatment may be granted to juridical persons owned or controlled by natural persons of developing country parties in the context of an economic integration agreement involving only developing countries;
- subject to Art. V bis labor markets can be integrated, with an agreement establishing full integration of the labor markets;
- according to Art. XIV and XIV bis, general exceptions, such as customary practices in international trade, and in some special circumstances, as with the avoidance of double taxation, for the protection of public morality, etc and certain security exceptions for the protection of Member's essential security interests, may be sufficient to exempt the Members from GATS obligations, inclusive of MFN obligations;
- according to Art. XIII, government procurement shall be excepted from Art. II.

In order to apply the MFN principles properly, clarification of some of the key

[41] WTO, "Services: rules for growth and investment" (1998), online: <http://www.wto.org/english.thewto_e/whatis_e/tif_e/agrm5_e.htm> (date accessed: 03/03/2001).

terms and concepts is highly necessary. The following are a clarification of some of these key terms:

- "no less favorable than": first, the MFN principle requires each Member, as a general obligation, to accord to any other Member treatment equal to that which it grants to any other country. Furthermore, although the MFN pledge does not require a Member to accord to any other Member treatment more favorable than that extended to any third country, it does not bar granting any other member additional favors exceeding those extended to any third country. Under such circumstances, other Members are accordingly entitled to claim the same additional favors and enjoy them as a new standard of FMN treatment.
- "like services" and "like service suppliers": unlike the notion of "like products" applied in Article I of GATT where one can usually rely on the customs classification of goods in the determination of the "likeness of products," not only is there no such nomenclature to refer to determine "like service" and "like service supplier" but there are difficulties in distinguishing "like services" from "like service suppliers" which are intertwined most of the time.[43] For instance, how to identify a "like service" when the same service has been supplied through different modes of delivery and even by different means and ways or by different categories of service suppliers?[44] At which time point should the likeness of services and service suppliers be determined in case services are provided in the form of processes (their content and characteristics may not be

[42] Yi Wang, *supra* note 29 at 111-115.
[43] See *supra* note 5.

fully known until they are delivered)? What aspects should be taken into consideration to distinguish them when services and service suppliers are intertwined? From an array of different interests and perspective, the granting state and the beneficiary state may specify likeness in a sector or sub-sector or examine every respect of the process to determine the likeness.[45] Obviously, we can not find a solution through interpretation of the Articles in GATS or its negotiating history. Perhaps the Council for Trade in Services should have some function in this connection.

- "the origin of services and service suppliers": services and service suppliers will also need to have their origins in the Member claiming the MFN treatment. Evolved in the context of trade in goods, the rule of origin is intended to have two functions: the specification of the criterion for determination of the origin of products, and procedures concerning the provision of formalities and certifications for verification purposes. Compared with the rule of origin in the context of trade in goods where there are conventions such as the Kyoto Convention and Agreement on Rules of Origin[46] and commonly accepted principle – the last substantial transformation principle for determination - there is no guideline for the determination of the origin of services and service suppliers. Some scholars suggest the origin of services may be based on the nationalities of the producers. Simple as it is for determination, it fails to reflect

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[44] Yi Wang, *supra* 29 at 98.
[45] Aly K. ABU-AKEEL, "The MFN as it Applies to Service Trade: New Problems for an Old Concept" (1999) 33:4 Journal of World Trad 103 at 113-115.
[46] *Kyoto Convention and Agreement on Rules of Origin* (Kyoto, 18/05/1973) Annex D 1-4, online: World Customs Organization <http://www.unece.org.trade.kyoto/ky-01-e0.htm> (date accessed:03/03/2001).

the economic rationale of the notion of origin.[47] Some scholars suggest adopting "substantial input" as an origin rule for services grafted from the "substantial conformation" origin rule for goods. However, considering the services provided by transnational corporations through their branches all over the world and the close connection of services with telecommunications and the easy "input" of key information in seconds, such a ruling will encounter great difficulty in formulation and administration. Another barrier for implementation of this rule may be derived from the characteristics of service itself. Services generally are processes and some of these processes last quite a long time. Therefore, before its final completion, any determination is unlikely to make much sense.[48] The Council for Trade in Services of the WTO still has a number of hard nuts to crack.

Overuse of Article II 2 exemptions as negotiation leverage for market access would undermine the functioning and credibility of unconditional MFN treatment and result in retrogression in the liberalization of trade in services under GATS. Notwithstanding the gap between the ideal and the reality in this connection, an unconditional MFN should always be the common goal for all Members.

C. National Treatment and Market Access

"Love thy neighbor as thyself" is a vivid reflection of the obligation incumbent on

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[47] *Supra* note 45 at 113-115.
[48] Aly K. Abu-Akeel, "Definition of Trade of Services under the GATS: Legal Implications" (1999) 32:2 The George Washington Journal of International Law and Economics 189 at 204-207[hereinafter "Definition of Services"].

Members regarding national treatment. Compared with the obligation of National Treatment (NT) in the GATT, the NT obligation in GATS has a much wider scope but limited application since it covers measures affecting both services and service suppliers but limits its application to scheduled sectors.[49] Article XVII, paragraph 1 of GATS states that: "In the sectors inscribed in its schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers."[50]

"Market access" is more flexible than "national treatment" and often used in conjunction with "national treatment." In one way, "market access" may be viewed as "better than national treatment" when eccentric or protective domestic rules result in de facto deprivation of market access to that country. This principle may require a degree of harmonization downward. Another view refers "market access" to initial entry or licensing, rather than to regulation of operation. Article XVI, paragraph 1 of the GATS states that: " with respect to market access through the modes of supply identified in Article I, each member shall accord services and service suppliers of any other Member treatment no less favorable than that provided for under the terms, limitations and conditions agreed and specified in its Schedule." Article XVI, paragraph 2 provides that measures restrictive of market access that a WTO Member cannot maintain or adopt, unless specified in the

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[49] Aaditya Mattoo, "National Treatment in the GATS: Corner Stone or Pandora's Box?" (1997) 31 Journal of World Trade 107 at 107.

Schedule, include limitations on:

- the number of service suppliers;
- the total value of service transactions or assets;
- the total number of service operations or the total quantity of service output;
- the total number of natural persons that may be employed in a particular sector;
- specific types of legal entity through which a service can be supplied;
- foreign equity participation.

It should be clearly noted that there is no clear line of demarcation between the domain of "market access" and "national treatment" under GATS. The wording of "all measures affecting the supply of services" in Article XVII indicates its coverage of both rights to establish and post – establishment treatment including all those quantitative measures listed under Article XVI. Then one may ask if Article XVI permits a certain redundancy. [51]One interpretation is that Article XVI attaches more emphasis on non-discriminatory market access restrictions and functions somewhat as a guideline. This problem may be observed during the scheduling process. Where one member made no commitment to market access while making a commitment to provide full national treatment, then there would be a dilemma if the member concerned looks for measures inconsistent with both Articles XVI and XVII. If the member is obliged to respect obligations under national treatment respecting all measures including those falling within Article XVI, then the member's "unbound" inscription respecting "market access" would have

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[50] *Supra* note 11.
[51] Aaditya Mattoo, *supra* note 49 at 113-115.

considerably less significance; if the member's "unbound entry" were to be qualified to those measures inconsistent with both XVI and XVII, then the commitment respecting national treatment would be impaired. Considering the rationale of GATS – liberalization of trade in services - Members should avoid contradictory commitments between market access and national treatment. When such situations actually occur, national treatment should be so interpreted as to include the overlapped part of inconsistent measures.

PART II: LIBERALIZATION OF CHINA'S FINANCIAL SECTOR

I. THE STRUCTURE AND DEVELOPMENT OF CHINA'S FINANCIAL SECTOR

A. Financial Institution Structure and Development

Prior to 1979 when China embarked on a process of financial reform, China's financial system was virtually a mono-banking system, which was composed of the People's Bank of China (PBOC), the Bank of China (BOC) and the People's Construction Bank of China (PCBC).[52] These institutions were not run on a market-oriented basis but on an administrative basis: their funding was allocated from the national budget, their operations were closely directed by the government, and literally served as cashiers to state owned enterprises.[53] With the progress of economic reform, this mono banking system became increasingly incompatible with the emerging economic system. To remedy these problems, the Chinese

[52] Priya Basu, *Creating Resilient Financial Regimes in Asia: Challenges and Policy Options* (Hong Kong: Oxford University Press, 1997) at 47-52.

Government began to reform its financial sector incrementally. From 1979 to 1984 the Chinese government gradually turned the PBOC into a central bank and set up four state owned specialized banks and other financial institutions; from 1985 to 1998 it diversified its financial system and furthered its reforms in this sector; from 1999 onward, with the imminent access to WTO, it began to overhaul its bad loan ridden financial system.[54]

i) The Central Bank: the People's Bank of China

The central bank of China – the People's Bank of China - was established in Shijiazhuang of Hubei Province, on December 2, 1948.[55] Prior to 1979, the PBOC functioned both as a central bank and a commercial bank. The main functions of the PBOC included the following:[56]

- issuance of money and control of money supply;
- supervision and control of financial operations of government agencies, state owned enterprises, and cooperatives through a specified cash management plan;
- supervision and control of foreign exchange;
- receiving deposits from households and firms;
- making loans and providing clearance services for business entities.

Under the planned economy the main function of the banking system was to provide working capital to state owned enterprises. The role of financial

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[53] Wu Xiaoling, "China's Financial Institutions" in On Kit Tam, ed., *Financial Reform in China* (London: Routledge, 1995) at 113-117.
[54] Lawrence L. C. Lee, "Integration of International Financial Regulatory Standards for Chinese Economic Area: The Challenge for China, Hong Kong, and Taiwan" (1999) 20 Northwestern Journal of International Law and Business 1 at 12-13.
[55] Cecil R. Dipchand et al., *Chinese Financial System* (London: Greenwood Press, 1994) at 5.
[56] *Ibid.*

intermediation was limited. Most investments were financed through government budgetary allotments rather than through the banking system.[57]

Since the inception of economic reform, the Chinese government began to realize the need to transform its mono-banking system. In September 1983, the Chinese government restructured the PBOC into a central bank. Its commercial businesses were assigned to four state-owned specialized banks, namely, the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC), the People's Construction Bank of China (PCBC)[58], and the Agriculture Bank of China (ABC), which were established during the period of 1979 – 1984. Nevertheless, the PBOC continued some of its commercial business activities until 1994 when the Chinese government initiated more extensive financial reform. In 1995 China passed its *Central Bank Law*.[59] It clearly prevented the PBOC from financing government deficits and from making loans to any kind of central and local government agencies.[60] *The Central Bank Law* specifies the objective of monetary policy as maintaining monetary stability to facilitate economic growth.[61] *The Central Bank*

[57] Baizhu Chen et al., "An Overview of China's Financial Markets: Progress, Problems and Prospects" in Baizhu Chen et al., eds., *Financial Market Reform in China: Progress, Problems, and Prospects* (Boulder, Colo,: Westview, 2000) at 6-7.
[58] In 1998 it was renamed as the China Construction Bank and accordingly in the short form CCB.
[59] *The Central Bank Law of PRC* (adopted on 18/03/1995 by the 3rd Session of the 8th National People's Congress), online:<http://www.csrc.gov.cn/CSRCSite/flfgk/zgrmyhfml.htm>; online: unofficial English translation <http://www.gchinalaw.com/cnlaw/reference/codes.fin&bank/peoboc.htm> (date accessed: 06/03/2001) [hereinafter *Central Bank Law*]
[60] Art. 28 of the *Central Bank Law* states that the PBOC shall not finance government budget deficits, shall not directly purchase or underwrite on sole agency basis state bonds and other government debentures; Art. 29 states that the PBOC shall not make loan to local governments and various levels of central and local government agencies; the PBOC shall not make loans to non-bank institutions, other entities and individuals.
[61] *Supra* note 59 art. 3.

Law of PRC legislates that the PBOC is responsible for:[62]

- formulating and carrying out monetary policy;
- issuing RMB and controlling RMB circulation;
- approving and supervising financial institutions;
- supervising financial markets;

Although the *Central Bank Law* grants the PBOC a considerable degree of independence from local governments, other ministries, state entities and individuals that had had a heavy influence on its operations in the past, nonetheless *the Central Bank Law* failed to transform the PBOC into a truly independent central bank capable of carrying out monetary policy without being influenced by government politics.[63] Firstly, the PBOC carries out its responsibilities under the leadership of the State Council;[64] secondly, the decisions made by the PBOC respecting the money supply, interest rates, exchange rates, and other important matters must be approved by the State Council.[65] Since the State Council has the final say on many important issues, political considerations are inevitably an important factor in the formulation of monetary policies. Notwithstanding the tendency that most central banks in the world are gaining more independence, it is

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[62] *Supra* note 59 art. 4.

[63] Originally the PBOC had branches in each Province and the personnel of these branches were partially decided by the provincial governments. Consequently, the provincial governments had great influence on the activities of these branches. After 1998, the PBOC restructured its branches and retained 9 regional branches that now have jurisdiction over a number of provinces so as to improve the control of the PBOC over monetary policy making.

[64] *Supra* note 59 art. 2 states that the PBOC formulates and implements monetary policies and supervises financial institutions under the leadership of the State Council; art. 7 states that, under leadership of the State Council, the PBOC independently implements monetary policies, carries out duties and operates business without interference from local governments, ministries, social entities and individuals.

[65] See *Central Bank Law, supra* note 59 art. 5.

unlikely that the Chinese government will empower the PBOC with complete autonomy in monetary policies in the foreseeable future.

ii) Commercial Banks

According to the *Commercial Bank Law of the PRC*[66] passed in May 1995, commercial banks referred to legal persons established to absorb public deposits, issue loans, arrange the settlement of accounts and engage in other businesses.[67] The present commercial bank system is composed of, on the one hand, four huge state commercial banks, created initially as specialized banks for separate sectors of the economy; on the other hand, in their shadows are 11 smaller commercial banks with either regional or national coverage.[68]

a) The Four State Banks

The four state banks, namely the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), the Agricultural Bank of China (ABC) and the China Construction Bank (CCB) were set up to take over specific forms of business from the PBOC.[69] Therefore, before 1995 they were ranged among specialized banks.

1) The Industrial and Commercial Bank of China (ICBC)

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[66] *The Commercial Bank Law of PR China* (adopted on 10/05/1995 by the 13th Meeting of the Standing Committee of the 8th National People's Congress, came into force on 01/07/1995), online: <http://www.csrc.gov.cn/CSRCSite/shangyeyml.htm>; online: unofficial English translation <http://www.com-law.net/findlaw/combank.html> (date accessed: 07/03/2001)[hereinafter *Commercial Bank Law*].

[67] See *Commercial Bank Law, ibid.* art. 2.

[68] Xiaoping Xu, *China's Financial System under Transition* (New York: St. Martin's Press, 1998) at 20.

[69] *Ibid.* at 23.

The ICBC was established in 1984 to take over the commercial banking operation of the PBOC. Since its establishment the ICBC has been the largest bank in China both in terms of assets and domestic business operations.[70] The main functions of the ICBC include the following:

- absorbing household and enterprise deposits, mainly in urban areas;
- lending to commercial and industrial firms in urban areas, mainly state-owned enterprises;
- payroll management and cash management for state enterprises.

However, its huge loans to state enterprises mean that it is difficult to transform it into a modern bank capable of competing with foreign banks with China's access to the WTO.[71]

2) *The Bank of China (BOC)*

The BOC was first established in 1912, offering basic services such as deposit-taking, loan-making and currency exchanges while also assuming certain responsibilities of the central banks. When the People's Republic of China was founded in 1949, the BOC actually became the foreign exchange department of the PBOC, although to the outside world it was still an independent bank. In 1979, China embarked on its policy of economic reform and began opening up to the outside world. The BOC subsequently became a wholly state-owned foreign-exchange and trade bank, playing a vital role in trade finance as well as in

[70] The total assets of ICBC was RMB 3,539.866 billion in 1999 according to ICBC balance sheet 1999; it ranked 18th worldwide by size of assets. See *supra* note 19.

international fund-raising. From 1984 to 1994, the BOC was also responsible for the management of state foreign exchange reserves.[72] Since 1995, the BOC has pressed ahead with reforms and innovations, and transformed itself from a specialized foreign exchange bank into a state-owned commercial bank, making considerable progress in all banking business areas. In the middle of 2000, its assets, including wholly-owned subsidiaries, reached RMB 2.97 trillion ($ 359.5 Billion) and it had 14,369 domestic branches and sub-branches and 557 overseas offices.[73] With the extensive consolidation of the Bank of China Group in Hong Kong and the development of the wholly-owned investment banking subsidiary-Bank of China International - the BOC is presently undergoing preparation for competition after China's approaching access to the WTO and the liberalization of its financial market. It's widely believed that the BOC will be the first to go public among China's "big four."[74]

3) *China Construction Bank (CCB)*

The CCB was set up in October 1954 to handle budget appropriations for capital construction and to supervise the use of these funds. The CCB was made responsible to the Ministry of Finance. Until 1979 all budgetary funds allocated through the CCB were interest-free grants and with no repayment requirements. After 1979 the CCB began to develop its commercial banking business, and thus

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[71] The share of loans was still 64 percent of its assets in 1999, most of these are unperformed loans to state enterprises according to its balance sheet 1999; its pre-tax return on assets was only 0.12%. See *ibid.*

[72] Francis A. Lees and K. Thomas Liaw, *Foreign Participation in China's Banking and Securities Markets* (Westport, CT: Quorum Books, 1996) at 26.

[73] Statistics see the BOC homepage, online: <http://www.bank-of-china.com> (date accessed 07/03/2001).

changed from being merely a fund distributor of the government to being more like a commercial bank. 1994 was a turning point for the CCB since it turned over its functions of fiscal agent and policy lending to the Finance Ministry and newly established State Development Bank respectively. Since then it has undergone a series of reforms regarding capital management, credit control, finance management and accountancy verification and it has also completed mergers of provincial branches with the city branches of the same location, and eliminated some small and unprofitable county level branches and operating offices. Its assets stood at RMB 2,201.065 Billion and its profits before income tax reached RMB 7.4 billion.[75] It also set up a joint venture with Morgan Stanley – China International Capital Corporation Limited - functioning as China's first investment bank. The CCB is also considering going public.

4) The Agriculture Bank of China (ABC)

The ABC was first set up in 1955 but merged in the PBOC in April 1957. It was revived in 1963 as an independent bank directly under the leadership of the State Council but merged again with the PBOC in November 1964. In February 1979 the ABC was reestablished by the State Council. Before 1994 the main functions of ABC included: distributing farm subsidies, providing financial services to rural residents and institutions, making government loans to the countryside, and supervising rural cooperatives. In April 1994, the Agricultural Development Bank of China was separated from the ABC to independently handle capital for grain,

[74] "Bank of China to be listed within two years" *People's Daily* (overseas) (10/08/2000) 3.

cotton and edible oil purchase and policy loans. The ABC began its transformation to a modern commercial bank according to the provisions of the 1995 Commercial Bank Law of PRC and it expanded its services to urban residents and all kinds of enterprises.[76]

b) Other Commercial Banks

Besides the "big four," there are other banks which were established in the 80's and 90's. Compared with the "big four" which are solely state-owned, most of these smaller banks were share-holding banks invested by state-owned enterprises and ministries and established as commercial banks from the beginning. These banks with national business include the following: the Bank of Communications, the CITIC Industrial Bank, the Hua Xia Bank, the Everbright Bank, the Min Sheng Bank, the China Investment Bank. Those with regional business include the Pu Dong development Bank, the Shen Zhen Development Bank, the China Merchant Bank, the Hai Nan Development Bank,[77] the Fujian Industrial Bank. In this section we will discuss two banks in detail – the Bank of Communication, which is the

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[75] See Balance sheet of CCB (1999), online: the CCB <http://www.ccb-on-line.com/about/1999.pdf> (date accessed 08/03/2001).
[76] See "The vicissitude of the ABC" online: the ABC <http://www.abocn.com/nhwz/nhjj/nhgk/lsyg.html> (date accessed: 07/03/2001).
[77] The Hainan Development Bank was founded in august 1995. The Hainan Provincial Government held a 30 percent stake in the bank; other shareholders included some state-owned enterprises. In 1997 the Hainan Provincial government asked the bank to merge 28 credit cooperatives that were plagued with serious bad debt problems. The credit cooperatives that the bank took over had assets (virtually all non-performing loans) of RMB 13.7 billion and liabilities of RMB 14.2 billion. The PBOC allocated RMB 4 billion to cover the bad loans. The credit cooperatives finally brought the bank down and the PBOC closed the bank on June 21, 1998. It was the first bank in the country to be shut down since the establishment of the PRC. However, the bank was not declared bankrupt. Instead, the Chinese government called in the ICBC to pay in full all the bank's overseas and domestic creditors. Depositors were also insured. See Brue Gilley, "Breaking the Bank" *Far Eastern Economic Review* (16/07/1998).

largest besides the "big four" and the Min Sheng Bank, which was invested mainly by non-state enterprises.

1) Bank of Communication

The Bank of Communication was first established in 1908 and reconstituted in 1987 as the first share holding commercial bank in China, with the PBOC and Shanghai Municipality as its main share-holders.[78] As a pilot project of China's financial reform, the Bank of Communication has drawn on the management experience of Western commercial banks and introduced a kind of corporate governance regarding the decision making process, prudent accounting principles, assessment, responsibility and performance targets.[79] The assets of the Bank of Communication in1992 were RMB 157.05 billion, but by the end of 1999 its assets reached RMB 538.049 billion and realized profits of RMB 2.583 billion. It was ranked 129 among the 1000 largest banks world wide according to the 1999 Banker.[80] It is widely believed that the Bank of Communication will go public in recent years and thereby accumulate experiences for the "big four" to go public when China phases out the restrictions in its Financial sector after its accession to the WTO.

2) Min Sheng Bank

If the Bank of Communication represents the reform direction of state owned banks, the Min Sheng Bank epitomizes the future of private banks in China. The Min

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[78] Francis A. Lees and K. Thomas Liaw, *supra* note 72 at 26.
[79] See "An Overview of the Bank of Communication" online: the Bank of Communication <http://www.bankcomm.com/jiaohangjingwei/frame_3.htm> (date accessed: 08/03/2001).
[80] *Ibid.*

Sheng Bank was established on 12 January 1996 in Beijing through the method of promotion. Of its registered capital of RMB 1.38 billion, 85% is from non-state owned enterprises.[81] It is the first commercial bank set up in accordance with the 1995 *Commercial Bank Law* and the 1993 *Company Law*.[82] The bank's business focus is on developing China's medium-sized and small enterprises and private firms, especially those in the high-tech sector. On 27 November 2000 it went public successfully: the offering was oversubscribed by a whopping 97 times and managed to raise an astounding RMB 401.43 billion (US$ 48 billion).[83] Its successful offering, on the one hand reflects the limited investment vehicles in China, on the other hand, it also shows the confidence of investors in private banks. Since its establishment, its profits and assets have been increasing steadily. The specific increase rates from 1996 to 1999 are, respectively: 88%, 17%, 54%, 117%, and 37%, 44%.[84] The Min Sheng is also notable in that it is the only bank in China that has hired an internationally recognized accounting firm to audit its financial statements. Its successful offering will have far reaching implications on the development of private banks in China.

iii) Policy Banks

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[81] See "Min Sheng De Mintian," online: Min Sheng homepage < http://www.cmbc.com.cn/about/bottom.html> (date accessed: 08/03/2001).

[82] *Company Law of the PRC* (adopted at the 5th Meeting of the Standing Committee of the 8th National People's Congress on 29/12/1993 and effective as of 01/07/1993; revised at 13th Meeting of the Standing Committee of the 9th NPC on 25/12/1999), online: <http://www.csrc.gov.cn/CSRCSite/>; online: unofficial English translation <http://www.jus.uio.no/lm/china.company.law.1993> (date accessed: 10/03/2001)

[83] "Min Sheng Shixiang Ziben Shichagnonline" (2000), online: Min Sheng bank <http://www.cmbc.com.cn/news/news17.html> (date accessed: 08/03/2001).

[84] "Min Sheng Yinglai Xinjiyu" (2000),online: Min Sheng bank <http://www.cmbc.com.cn/news/news18.html> (date accessed: 08/03/2001).

Policy banks refer to financial institutions established, invested or guaranteed by the government to engage directly or indirectly in financial activities so as to carry out the economic policy and industrial policy of the government.[85] There are three policy banks, which were established after 1994 to assume the policy-lending role of the solely state-owned banks and, through their activities, to relieve the need for the central bank to indirectly fund the capital requirements of policy lending. Initially the government considered transferring the existing policy loans of the "big four" to the policy banks, but when it realized that such a transfer might dramatically shrink the assets of the big four and result in their insolvency, they abandoned this plan. The three policy banks are:[86]

a) *Agriculture Development Bank of China*: it was established with registered capital of RMB 20 billion and its primary role is to finance the purchase and storage of crops from farms and agriculture-related capital investments;

b) *Export-import Bank of China*: it was created primarily to provide export sellers' credit to promote the sales of Chinese products in foreign markets. The bank has also assumed the responsibility for handling the concessionary loans that China receives from industrialized countries and the concessionary loans that China makes to countries in Africa and Latin America.[87]

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[85] Wang Baoshu, *Shangfa Yu Jingjifa* (Beijing, Legal Press, 1999) at 341.
[86] Xiao Gang, *The Banking Financial Industry in China* (Beijing: China Financial Publishing House, 1999) at137

c) *China Development Bank*: it provides capital for state-supported infrastructure and technology projects. In 1999 twenty regional branches of the former Investment Bank of China, a state-run commercial bank that funds major infrastructure projects across China, was transferred to the China Development Bank. This change made it possible for the China Development Bank, which previously had had no branches, to manage its own loans. It now has over RMB 500 billion in assets.

These policy banks basically accept no deposits and they obtain funding by issuing bonds. The three policy banks have grown considerably over the years and their total assets now account for around 10% of those of the national banking system. They are initially funded by the state through state-supported domestic and international bond issues. Their source of funds comprise state budgetary appropriations, the sale of financial bonds to other banks and non-bank financial institutions, loans from international organizations and foreign governments, and borrowing from the central government. Initially, the policy banks were established to extricate the "big four" from policy loans. Ironically, the "big four" were forced to buy the bonds of the policy banks with paid interest rates well below the rates on state treasury bonds of comparable maturity. The great demand for policy funding in China will nevertheless ensure the increasing importance of the policy banks.

iv) Credit Cooperatives

Representing slightly less than 10% of total banking assets, the credit cooperatives

[87] Tong Ting, "Eximbank's Functions Strengthened" *China Daily Business Weekly* (01/06/1995) at 3.

can generally be divided into rural and urban cooperatives. At the end of 1999, there were 41,755 rural cooperatives and 836 prefecture-level (just above county level) urban cooperatives.[88] The cooperatives provide credit to small collectives, midsize urban enterprises, and individuals. With progress of the reforms in the financial sector, both rural and urban cooperatives function under the supervision of the PBOC. A deposit insurance scheme for the urban and rural credit cooperatives will be established in the near future.[89]

a) Rural Credit Cooperatives (RCCs)

The Rural Credit cooperatives have existed in China since the early 1950s and experienced some set-backs over the 1958-1978 period. Having undergone a series of reform, the rural credit cooperatives now play a major role in rural financial activities.[90] Since the RCCs are mainly located in the townships of rural areas, they were once directly supervised by the ABC. Local ABC branches offered consultancy and financial services to federations of the RCCs. To meet the needs of rural enterprises and residents, the RCCs set up numerous credit stations staffed with part-time employees. The RCCs are owned collectively by farmers through equity stocks. The management power of the RCCs rests with the annual Farmer's Representative Conference, wherein management reports to the shareholders. Rural households and collectively owned enterprises deposits are the main funding source

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[88] See statistics, online: the PBOC <http://www.pbc.gov.cn/trsweb/Detail> (date accessed:15/03/2001).

[89] "Opening Address of Mr. Dai Xianglong-the Governor of the PBOC at the BIS & the PBOC Joint Conference in Beijing" (1-2 March, 1999), online: <http://www.bis.org> (date accessed: 16/03/2001).

[90] Eric Girardin, *Banking Sector Reform and Credit Control in China* (Paris: Development Center of OECD, c1997) at 38.

of the RCCs.[91] The main functions of RCCs can be summarized as follows:

- collecting idle funds in rural areas, taking in deposits and providing funds for rural development;
- handling the settlement of accounts and the control of cash in rural areas;
- training and guiding the book-keepers of other collectives in proper cash management;
- assisting rural businesses and residents with financial problems in order to minimize usury.[92]

b) Urban Credit Cooperatives (UCCs)

The first urban credit cooperative emerged in 1979, as a response to urban economic reforms that led to an increase in collectively owned and privately owned enterprises.[93] Two factors, namely, the low entry capital requirement (RMB 100,000) and the tight credit control to collectively and privately owned enterprises, contributed to the fast expansion of the UCCs before 1988. Accordingly, the necessary enabling legislation, the *Provisional Regulations for the Administration of the UCCs*, was passed in July 1986.

Like the RCCs, the UCCs are independent legal entities with separate accounting, independent operation and sole responsibility for profits and losses. Regarding its organization, the UCCs can be ranged among membership financial institutions,

[91] Baizhu Chen et al., "An Overview of China's Financial Market" in Baizhu Chen et al., eds., *supra* note 57 at 19.
[92] Eric Girardin, *supra* note 90 at 39.
[93] Eric Girardin, *ibid.* at 42.

with residents and collectively owned enterprises as their shareholders. These shares may be transferred or inherited but are not allowed to be withdrawn.[94]

The rapid expansion of the UCCs was accompanied by high-risk loans, the low quality of assets and the blind pursuit of an indiscriminate number and size of loans. In 1989, an explosion of the UCCs' credit activities occurred because most the UCCs exceeded their credit ceilings. Meanwhile, the intervention by local governments in the operation of the UCCs began to impair the autonomy of the UCCs. Taking deposits from and granting loans to unauthorized customers constituted another problem. To remedy the situation, the PBOC issued its *Regulation on the Management of the UCCs* in 1989, which further clarified the scope of business of the UCCs and provided operating guidelines for them. The regulation specifies the scope of business as follows:

- collecting deposits from, granting loans to and conducting settlement transactions for private enterprises, urban collectively owned enterprises and small state enterprises. The UCCs shall not conduct business relative to investment and leasing;
- collecting deposits from urban individuals;
- dealing with the securities business on behalf of securities firms;
- collecting premium and other commissions and making payments on behalf of insurance companies and other financial institutions;
- conducting other business approved by the PBOC.

[94] Eric Girardin, *ibid* at 45.

With the furtherance of financial reform, especially after the *Commercial Bank Law* came into force in 1995 , the UCCs in some cities began to consolidate and emerge as full-fledged commercial banks.[95] For example, the Beijing Urban Cooperative Bank was formed in 1996 through the merger of ninety local UCCs; the Shanghai City United Bank, the largest of the cooperative banks, was organized through the consolidation of more than one hundred local UCCs in the city.[96] The Chinese government will also consider establishing a deposit insurance scheme for the UCCs and RCCs so as to make them serve as proper cooperative financial institutions with the major equity holders, management team and clients from the local community.[97] Notwithstanding all the problems, the UCCs have performed a useful role in the Chinese Economy through centralizing idle funds and strengthening private enterprises.

v) Other Non-bank Financial Institutions

Besides the RCCs and UCCs, there are some other types of non-bank financial institutions in China which began to spring up in the mid-80s. Due to lack of regulation, they enjoy a very broad scope of business. These non-bank financial institutions include trust and investment companies, securities firms, insurance companies, and finance companies.

a) Trust and Investment Companies (TIC)

[95] Art. 13 of the *Commercial Bank Law* states that the minimum registered capital for setting up an urban cooperative bank is RMB 100 million.
[96] Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Washington D.C: Brookings Institution Press, 1998) at 72 [hereinafter *Unfinished Revolution*]

The TICs trace their roots back to 1979, soon after the launch of China's economic reform and opening-up policies. Their establishment and growth were fueled by the market demand for more financial sources other than the state owned banks, whose scope of business was tightly restricted. The TICs also reflected the conflicts arising from the growth of new, innovative financial institutions within the framework of a large traditional financial sector experiencing a comparatively slow reform.[98] As a result, their development has been characterized by a cyclical swing of rapid expansion, tight control and consolidation. With the State Council's approval to set up the China International Trust and Investment Company (CITIC) in 1979 to help the central government to raise foreign funds for strategic projects, other TICs mushroomed across the country. By the end of 1982 the number of TICs rocketed to 620, of which 568 were operated by banks and the others belonged to the local governments.[99] Because the rapid growth of the TICs began to pose a threat to the dominant position of banks, and the TICs also sidestepped the credit plan of central government, the Chinese government forbade non-financial institutions to set up TICs and brought the business of the TICs under the scope of the Credit Plan. In 1983 the PBOC began to be responsible for supervision of the TICs and issued A Number of Rules on Opening up Trust Business,[100] in which the scope of trust business was defined as "trust, lease, agency, and consultation." With a new round of TICs' overheating financially, the PBOC temporarily suspended the trust loans and investment business of the TICs. The Interim Rules on the Administration of

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97 Eric Girardin, *supra* note 90 at 47.
98 Anjali Kumar et al., *China's Non-Bank Financial Institutions: Trust and Investment Companies* (Washington D.C: The Word Bank, 1997) at 1.
99 *Ibid.* at 3.

Financial Trust and Investment Companies[101] issued by the PBOC led to yet another booming of the TICs. By the end of 1988 the number of the TICs once again reached 745. To avoid "economic bubbles," the PBOC once again tightened control and reduced the number of TICs to 339. With China's economy on a "fast track" after 1992, the lending rates of the TICs grew rapidly and gave rise to concerns about inflation and over investment beyond the credit plan.[102] *The Commercial Bank Law* also required banks to divest their trust business completely.[103] From 1995 on, the government has been endeavoring to both formalize the business and reduce the number of TICs. The 1997 Asia Financial Crisis made the government more determined to reorganize the TICs. The shock closure of Guangdong International Trust and Investment Corporation in February 1999, one of China's largest TICs, was as much a moment of awakening for foreign banks which had lent to Chinese institutions as it was a signal from China's banking authorities.[104] On January 19, 2001 the PBOC issued *Measures on the Management of Trust and Investment Companies* which set forth parameters for the defining and

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[100] *A Number of Rules on Opening up Trust Business* (1983), online: the PBOC :<http://www.pbc.gov.cn/finance/financce.html> (date accessed:17/03/2001).
[101] *Interim Rules on the Administration of Financial Trust and Investment Companies* (issued by the PBOC in1987), online: http://www.pbc.gov.cn/finance.html> (date accessed:17/03/2001).
[102] Anjali Kumar et al., *supra* note 98 at 2-3.
[103] Art. 43 of the *Commercial Bank Law* states that commercial banks shall not make trust investment, trade in shares or make investment in fixed assets other than those for self-use within the PRC. Commercial banks are not allowed to make investment in non-banking institutions and enterprises within the People's Republic of China. For investments made before the promulgation of this law the State Council will work out rules to deal with them.
[104] On January 16, 1999, the biggest bankruptcy in the history of the PRC was declared, when the GITIC filed for bankruptcy with total liabilities of US $ 4.3 billion and assets of US $ 2.6 billion and sought protection from its creditors under the PRC State Enterprise Bankruptcy Law of 1986. Whereas previous liquidations of insolvent financial institutions had been carried out under the central bank regulations,
wherein foreign creditors were repaid in full because of the letters of comfort or the word of the local government as a recourse in recovering loans. The foreign creditors that are owed US$3.7 billion may only be partially recovered. It is a difficult decision, but China must reform its financial sector.

licensing of the TICs. The PBOC also plans to reduce the number of the TICs from 239 at present to 40.

China's TICs can be divided into two broad types: those that are internationally oriented and those that are domestically oriented.[105] The best known among the former is the CITIC, chartered by the State Council in 1979. As a window to the outside world, it successfully attracted and raised a lot of funds in the international capital markets. The latter tended to specialize in long-term investments within China. Unlike trust companies in western countries, which aim to facilitate the transfer and management of properties, China's TICs were created to supplement the function of banks during the transition from a planned economy to a market economy. Actually, China's TICs basically performed the role of commercial banks with greater flexibility since the trustee pays settlors a fixed rate of interest, which was much higher than the rate paid by the banks.[106] According to the *Interim Rules on the Administration of Financial Trust and Investment Companies* [hereinafter *Interim Rules 1986*] issued by the PBOC on April 26, 1986, the scope of Business of the TICs was as follows:

- trust business specified by settlors;
- trust business in which the settlors stated some general requirement;
- leasing business associated with financing;

Inevitably the GITIC will not be the last to face bankruptcy. See Mary Kwang, "China's Financial System Rocked" *The Straits Times Interactive-Perspective* (14/02/1999) 6.

[105] Some scholars also specified five categories: those under direct supervision of the State Council, those sponsored by local government, those supported by firms in other industries, those founded by foreign banks or joint ventures, those as subsidiaries to commercial banks.

[106] Zhaohui Hong and Ellen Y. Yan, "Trust and Investment Corporations in China", in Baizhu Chen et al., eds.,supra note 57 at 286-291.

- agency services related to trust asset management, including collection, conservation, and issuing securities;
- securing and issuing RMB debt;
- other services approved by the PBOC.

It is apparent that the scope of RMB business, in addition to trust and entrusted loans and deposits, is defined to include a large variety of financial services, including both banking and traditionally non-banking services. Due to the state ownership structure and the constitution of clients, the losses would generally be born by the state rather than by the management.[107] Therefore, the TICs tended to engage in high-risk activities, such as investing heavily in real estate and stock speculation. Not surprisingly, most of the TICs in China are financially problematic. To mend the loopholes in the *Interim Rules of 1986* and to streamline China's TICs with international practice, the PBOC issued *Rules for the Administration of Trust and Investment Companies* [108]on January 19, 2001, which replaced the *Interim Rules of 1986*. These rules define a TIC as a financial institution dealing mostly in trust-related business and prohibit TICs from accepting deposits, issuing bonds or borrowing from overseas.[109] The rules specify the scope of business of the TICs as follows:[110]

- capital trust business;

[107] Most of China's TICs only receive their funding from other state-owned enterprises, state banks or local governments and ignore the provision of traditional trust services for individuals.
[108] *Rules for the Administration of Trust and Investment Companies* (issued by the PBOC on 19/01/2001), online: the PBOC homepage <http://www.pbc.gov.cn/news/Show.asp?b=143> (date accessed: 23/01/2001).[hereinafter *the New Rules*].
[109] *Ibid.* Arts. 2, 9.
[110] *Ibid.* Art. 21.

- movables, inmovables and other properties and property rights trust business;
- operating investment funds permitted by relevant laws and regulations, operating investment funds as promoters of a funds management company;
- enterprise assets reorganization, acquisition and other intermediary business such as project financing, finance management, and finance consultancy;
- underwriting state bonds and enterprise debentures as approved by relevant authorities of the State Council;
- debts warranty with its own property;
- property custody and disposition;
- credit witness, credit investigation and economic consultation;
- other businesses approved by the PBOC.

The *new Rules* made some progress in streamlining China's TICs according to international practice. The *new Rules* empowered the PBOC as the only supervision body to the TICs and ended the chaotic multi-supervision structure. The Rules specify the trustee's fiduciary duty and forbid guarantee against loss or the guarantee of a minimum income.[111] The rules also encourage the development of charitable trusts.[112] However, the scope of business is still relatively wide and ambiguous. Allowing trust companies to participate in other sorts of business concurrently with their trust operations could lead to the same problems once experienced by the TICs. These rules are transitory by nature and help to reduce the number of the TICs and afford a smooth transformation.[113]

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[111] *Ibid.* Arts. 30, 32(3).

[112] *Ibid.* Art. 22.

[113] *Ibid.* Art. 14 requires a registered capital of RMB 300 million for the establishment of a TIC. Most of the present TICs just can not meet this requirement. Some will be consolidated; some will

b) Securities Firms

Securities firms reemerged in China in September 1987.[114] Before the official opening of the Shanghai and Shenzhen stock exchanges in December 1990 and July 1991, respectively, these firms were restricted to carrying out over-the-counter transactions in stocks and in government bonds. With the rapid development of China's stock market, securities firms and TICs which engage in securities businesses mushroomed all over China.[115] By the end of 2000, there were 90 securities firms and 203 TICs that operate securities business and 95 securities investment consultant firms.[116] The Chinese securities firms are basically state owned because of the share holder qualification requirement.[117] Most of the shareholders are government ministries, local governments and other state owned enterprises.[118] Among these securities firms, the Guotai Securities, the Nanfang Securities and the Huaxia Securities possess a very prominent position in China's securities industry.[119] They were set up in September 1992 through investment by the "big four," the Communications Bank of China, the Investment Bank of China

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be closed. The TICs will be reduced to about 40 and eventually be re-registered according to the new rules.

[114] *Almanac of China's Finance and Banking 1988* (Beijing: China Statistical Press) at 142.

[115] The TICs, TICs can no longer operate securities businesses. Therefore some of the securities departments will probably be divested from the TICs to form independent securities firms; some will be consolidated with others and some will be closed. See *supra* note 108.

[116] "The CSRC Statistics" (2000), online: the CRSRC <http://www.csrc.gov.cn/CSRCSite/zjjg/zqjgdqfb.htm> (date accessed: 17/01/2001).

[117] Although it is widely believed that with China's access to the WTO, those securities firms could be listed at one of China's two stock markets, and consequently diversify the ownership structure.

[118] According to the *Commercial Bank Law*, state commercial banks shall not engage in trust and investment or stock business, or invest in non-bank financial institutions; but those that have done so prior to the effective date of this law shall be separately provided for by the State Council.

[119] With the booming economy Shanghai Shenying Wanguo Securities, a regional securities firm with headquarters in Shanghai, squeezed into the top 3 according to the value of its assets. The ranking of the top five in 1999 was as follows: Guotai Securities (total assets US $ 2,924 million),

and the People's Insurance Company of China to engage in nation-wide business in securities.

The passing of the *Securities Law of the PRC*[120] on December 29, 1998 relieved the chaotic situation in China's securities industry regarding its establishment, business scope and regulatory bodies.[121] Chapter VI of the *Securities Law* of specifically deals with securities firms. According to this law a securities firm is defined as a company with limited liabilities or a shareholding company that is examined and approved by the State Council's securities regulatory body to engage in securities business.[122] Securities firms are divided into comprehensive securities firms and brokerage securities firms. The requirements for the establishment of a comprehensive securities firm include:[123]

- a minimum registered capital of RMB 500 million;
- qualified managerial personnel and employees;
- a fixed operational site and up-to-standard trading facilities;
- a perfect management system and a standard operational system for its business and brokers.

Shenying Wanguo (US $2,023 million), Nanfang Securities (US$1,878 million), Huaxia Securities (US$1,337 million), Haitong Securities (US$1,241million) see *Zhengquan shibao* (10/05/ 2000) 2.

120 *The Securities Law of the PRC* (adopted at the 6th Meeting of the Standing Committee of the 9th NPC on 29/12/1998), online: CSRC homepage <http://www.csrc.gov.cn/CSRCSite/flfgk/securities01.htm>; unofficial English translation online: <http://www.gchinalaw.com/cnlaw/reference/codes/sec/security.htm> (date accessed: 03/02/2001)[herein after *Securities Law*]

121 Before passing of the *Securities Law*, China's legislator, government ministries, and local governments had passed over 250 laws, regulations, decrees, and circulars to regulate securities markets and securities firms. Consequently, there were jurisdiction overlaps and gray areas regarding the establishment and business scope of TICs and securities firms. These problems will be further discussed in the chapter about stock markets.

122 *Supra* note 120 Arts. 117, 118

123 *Ibid.* Arts. 121, 122.

The minimum registered capital for a brokerage securities firm is RMB 50 million. With regard to the scope of business, comprehensive securities firms shall operate the following types of securities business:

- securities brokerage business;
- securities proprietary business;
- securities underwriting business;
- other securities business approved by the State Council securities regulatory body.

Brokerage-type securities companies are allowed to operate brokerage business only.[124]

c) Insurance Companies

The People's Insurance Company of China (PICC) was established in 1949, but for more than 30 years under the command economy, it barely performed any of the functions of a financial institution. It ceased its domestic operations in 1959 and its foreign businesses were taken over by the PBOC.[125] The economic reforms of the early 1980's prompted the Chinese government to proceed with reforms of the insurance sector. The PICC resumed its normal operation in 1980 and became an independent institution under the direct supervision of the State Council in 1984. The establishment of Ping An Insurance Company in 1988 introduced some moderate competition into China's insurance market, which was dominated by the

[124] *Ibid.* Arts. 129, 130.
[125] Xiaoping Xu, *Supra* note 68 at 29.

PICC.[126] In 1991 another competitor – China Pacific Insurance Company[127]- came into existence. To meet the requirement of separate operation of property insurance and life insurance by the *Insurance Law of the PRC* of 1995[128], the PICC was divided into three independent companies: the PICC Property Insurance Company, the PICC Life Insurance Company and the PICC Reinsurance Company in 1996. The three were placed under the control of the newly established People's Insurance Group Corporation. In 1998, the People's Insurance Group Corporation was disbanded and the three PICCs were renamed People's Insurance Corporation of China (PICC)[129], China Life Insurance and China Reinsurance. Besides these "heavy weight players," ten other domestic insurance companies were founded during the nineteen-nineties to operate on a small scale in various regional markets.[130] By the end of November 2000, the insurance premium income reached RMB 14,303,0.86 million and the total assets of insurance companies reached RMB 31,740,9.28 million. The three PICCs together with Ping An Insurance and China Pacific Insurance accounted for over 95% of the total premium.[131]

Before the passing of the *Insurance Law* , the *Provisional Regulations on*

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[126] Ping An Insurance Company was mainly invested by the ICBC and its headquarters is in Shenzhen, Guangdong Province.
[127] The China Pacific Insurance Company was funded by the Communication Bank of China and its headquarters is in Shanghai.
[128] *The Insurance Law of the PRC* (adopted at the 14th Meeting of the Standing Committee of the 8th NPC on 30/06/1995 and effective as of 01/10/1995), online: CIRC: <http://www.circ.gov.cn>; unofficial English translation, online: <http://www.moftec.gov.cn/moftec/official/html/laws_and_regulations/finance3.html> (date accessed 17/01/2001) [hereinafter *Insurance Law*].
[129] It inherited the property insurance business of the former PICC. At first it was named China Property Insurance, but to avoid intangible assets loss of the brand of the PICC, China Property finally inherited the brand of PICC.
[130] Foreign and joint venture insurance companies will be discussed in the chapter on foreign participation.

Enterprises Administration issued by the State Council in 1985 had been the sole source of guidance for the insurance companies. *The Insurance Law* spelled out the basic legal structure of insurance companies and demanded the separate operation of property and life insurance. This law designated the PBOC as the regulatory body for the insurance companies. As with other Chinese laws, the *Insurance Law* became out-of-date immediately after its promulgation because of the fantastic expansion speed of this industry and the lack of prevision on the part of the Chinese legislators.[132] To implement the principle of separate operation in respect of banking, securities and insurance, and to ensure that the PBOC would concentrate on banking sector, in November 1998 the State Council set up the China Insurance Regulatory Committee (CIRC) to take over from the PBOC all the regulatory responsibilities of the insurance industry. Soon the CIRC found the Insurance Law of 1995 to be lacking in feasibility given the new economic situation. Consequently, on January 13, 2000, the CIRC issued its *Regulations on the Administration of Insurance Companies*.[133] These new regulations defined insurance companies as constituting various types of commercial insurance companies that were considered to have been registered in accordance with the law and which had therefore received approval for establishment from the insurance regulatory authorities.[134] When applying for the establishment of an insurance company, the following

[131] "The CIRC statistics" (2000), online: the CIRC < http://www.circ.gov.cn/tjsj/tjsj.htm>.
[132] Chinese legislators tend to enact laws to deal with problems already found and seldom take into consideration possible problems to be encountered in the future.
[133] *Regulations on the Administration of Insurance Companies* (effective as of on 01/03/2000 by the CIRC), online: the CIRC homepage: <http://www.circ.gov.cn/law/detail.asp> (date accessed: 20/01/2001).[hereinafter *Insurance Regulations*]
[134] *Ibid.* Art. 4, also see *supra* note 128 Art. 69, an insurance company shall take any of the following organizational forms: joint-stock company; or solely state-owned company.

conditions must be fulfilled:[135]

- minimum registered capital of RMB 500 million for an insurance company with nation- wide business; minimum registered capital of RMB 200 for a regional insurance company;[136]
- the senior management of an insurance company must meet the qualifications for taking up their posts set by the CIRC;
- national insurance companies engaging in the life insurance business must have at least three actuaries recognized by the CIRC; regional insurance companies carrying out life insurance business must have at least one actuary recognized by the CIRC;[137]
- the company must have a workplace and office facilities commensurate with the scale of its business and the number of its staff;
- the shareholders of a joint stock insurance company shall be legal persons or other organizations permitted by the state to engage in investment; moreover, qualifications of shareholders must be in line with the relevant CIRC regulations;
- other conditions that the CIRC may see fit to impose.

Unlike the business scope provided for in the *Insurance Law*, the business scope of insurance companies in the *Insurance Regulations* is very specific, and it is divided into the business scope of property insurance companies, the business scope of life

[135] *Ibid.* Art. 7.
[136] *The Insurance Law* doesn't distinguish insurance companies with national business or regional business. The minimum registered capital is RMB 200 million. See supra note 128 Art. 72.
[137] No such requirement was posited in the *Insurance Law*.

insurance companies, and the business scope of reinsurance companies.[138]

B. Structure and Development of Financial Markets

Along with the development of financial institutions, China's financial instruments and markets for short-term and long-term business also began to come into existence and gain momentum.

i) Stock Market

a) An Overview of the Development of the Stock Market

Before 1949, China once had the largest stock market in Asia. But stock trading and issuing was discontinued with the establishment of socialist China since stocks were considered the very incarnation of capitalism. With the progress of China's economic reform under the leadership of Deng Xiaoping, capital needs generated by economic restructuring could not be met by the traditional credit planning

[138] Business scope under the *Insurance law* is provided for as follows: 1) the property insurance business, including such insurance business as property loss insurance, liability insurance and credit insurance; 2) the life insurance business, including such insurance business as life insurance, health insurance and accidental injury insurance. By contrast the *Insurance Regulations* specify the scope of business as follows: 1) property insurance companies may carry on all or some of the following business: enterprise property insurance, domestic property insurance, construction project insurance, installation project insurance, carriage of goods insurance, motor vehicle insurance, marine insurance, aviation insurance, space flight insurance, energy insurance, statutory liability insurance, general liability insurance, guarantee insurance, credit insurance, crop insurance, breeding insurance, other property insurance business approved by the CIRC, and reinsurance for the above types of insurance; 2) life insurance companies may carry on all or part of the following kinds of business: individual accident insurance, individual fixed-term life insurance, individual endowment insurance, individual whole life insurance, individual pension insurance, individual short-term health insurance, individual long-term health insurance, group accident insurance, group fixed-term insurance, group whole life insurance, group pension insurance, group short term health insurance, group long-term health insurance, other life insurance business approved by the CIRC, and reinsurance business for the above types of insurance; 3) reinsurance companies may carry on all or some of the

system. The stock market came to life in the 1980s when provincial legislatures began to experiment with company regulations and local companies began to issue shares that were then sold to the public.[139] Shares issued to the public must have a channel through which they may be traded. In the first instance, certain secondary markets developed without the approval of the government. In 1986, the PBOC approved the first over-the-counter market in Shenyang, and then a small market for stock trading in Shanghai.[140] Soon after this, over-the-counter markets quickly sprouted in other cities. However, these securities dealing centers had only minimal quotation, clearing and settlement facilities. To cope with the increasing trade volumes, the Shanghai Stock Exchange (SHSE) was inaugurated on December 19, 1990, and later the Shenzhen Stock Exchange (SZSE) was established on July 3, 1991. Only eight stocks were listed when the SHSE started to operate. Over the years, the number of listed firms, trading volumes and total market capitalization have all increased dramatically. By the end of November 2000, the total market capitalization in these two exchanges had surpassed RMB 4.6 trillion with the number of investors opening an account in the bank exceeding 56 million and the market has realized non-paper circulation and dealing of stocks, funds and bonds.[141]

b) *Regulatory Structure of the Stock Market*

following kinds of business: accepting reinsurance business from property and life insurance companies, upon approval from the CIRC, accepting statutory reinsurance business from insurance companies inside China, as well as retrocession business and international reinsurance business.

[139] Baizhu Chen et al., "An Overview of China's Financial Markets: Progress, Problems and Prospects" in Baizhu Chen et al., eds., *supra* note 57 at 16.

[140] Xiaoping Xu, supra note 68 at 39.

[141] See speech of Mr. Zhou Xiaochuan, chairman of the CSRC at the China's Stock Market 10-Year Forum *Zhengquan Shibao* (16/12/2000) 1.

Although China's stock markets have allowed companies to raise much needed capital and have enabled the better managed state-owned enterprises to reform themselves through corporatization, they have also witnessed naïve investor enthusiasm, rampant speculation, dishonest manipulation and occasional scandals. The market cried out for proper regulation, but until the *Securities Law* was enacted, the regulatory framework had a necessarily makeshift nature. Some 250 sets of regulations, decrees, circulars, had been laid down by various governmental authorities with competing jurisdictions. The results were often inconsistent and unwieldy, creating a quite unsatisfactory situation. Due to the 1997 Asia Financial Crisis, the creation of this law required a cautious and evolutionary approach, as the stable and orderly development of the market was the top priority.[142] This law applies to the issue and transaction of stocks, company bonds and other securities recognized by the State Council within China. To the extent that the *Securities Law* makes no applicable provisions, the Company Law and the relevant regulations will continue to apply.[143] Before the establishment of the State Council Securities Commission (SCSC) and the China Securities Regulatory Commission (CSRC) in October 1992, which marked the formation of centralized regulatory bodies, the securities industry had been under the supervision and administration of the PBOC. The PBOC delegated some regulatory power to its provincial and municipal branches and exercised supervision through them. Meanwhile these branches worked closely with the local government. Putting local interests as the top priority, each PBOC provincial branch issued rules in accordance with own interests and a

[142] Li Yiqian, "Tough new blue-sky rules for the securities market"(1999), online: <http://www.china2thou.com/9903p4.htm> (date accessed: 18/01/2001).

fragmentary and inconsistent regulatory framework was the result. When they were first set up, the SCSC was the state authority involved with the power to exercise centralized market regulations and the CSRC was the SCSC's executive branch. In August 1997, the State Council put the securities markets in Shanghai and Shenzhen under the direct supervision of the CSRC. In April 1998, pursuant to the State Council Reform Plan, the SCSC and the CSRC were merged and the name of the CSRC maintained.[144] The function of the CSRC is:

- to establish a centralized supervision system for securities and futures markets;
- to strengthen supervision over securities and futures business and to raise the standard of information disclosure;
- to increase the ability to prevent and handle a financial crisis;
- to organize drafting laws and regulations for securities markets;
- To exercise centralized supervision of securities business.

Professor Li Yining, a well-known Chinese economist, once commented that China's Securities market reflected 'two Chinese characteristics': classification of shares into different types according to investor's identities and issuing stocks by use of a quota system.[145] Besides the theoretical classification of common shares, preferred shares etc, in China's securities market, shares are classified into the following four categories according to the investor's identity:

- Chinese individual shares refer to shares that represent the capital contribution

[143] Supra note 120 Art. 2.
[144] Chengxi Yao, *Stock Market and Future Market in the People's Republic of China* (Hong Kong: Oxford University Press, 1998) at 79-81.
[145] See "China to Forge a legal Economic Framework" *China Daily* (20/11/1993) 3.

to a corporation made by an individual Chinese citizen and these shares can only be possessed by Chinese citizens and can be freely traded and transferred in domestic markets;[146] these kinds of shares are denominated and payable in RMB and they are generally called 'A' share;

- State shares refer to shares held by governmental agencies or authorized institutions on behalf of the State, including the shares converted from the net assets of state owned enterprises that have been transformed into joint stock companies and those shares initially issued by governmental agencies and authorized institutions on behalf of the State. State shares are not tradable on an open market;[147]
- State-owned legal person shares refer to the shares of a joint stock company obtained by another state owned company using the state assets to which the company has a legal right to dispose.[148] The transfer and trading of legal person shares are also restricted at present;
- Foreign capital shares include domestically listed foreign person shares and overseas listed foreign person shares. The domestically listed foreign person

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[146] See *Provisional Measures on Shareholding System* (jointly issued by the State Economic Restructuring Committee, the State Planning Committee, the Ministry of Finance, the PBOC, and the State Council Production Office on 15 May 1992), online: the CSRC <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 19/01/2001).

[147] See *Provisional Measures on the Regulation of State-owned Share Rights Issued by Companies Limited by Shares* (jointly issued by the National Administration of State Assets and the State Economic Restructuring Committee on November 3, 1994), online: <http://www.csrc.gov.cn/CSRCSite/flfgk>(date accessed:19/01/2001).

[148] See *ibid.* The concept of state-owned legal person shares is peculiar to the evolution of China's public ownership system. In the early years of China's economic reform, as an incentive measure, the state-owned enterprises could retain part of the profit they produced. This part of the assets is generally defined as state assets which the enterprise has a right of disposal. With the progress of the corporatization of the state enterprises according to the *Company Law*, the legal person share became a more popular term for these shares, since they refer to the shares of a joint stock company owned by state-owned legal persons, collective enterprise legal persons, private enterprise legal persons, foreign investment enterprise legal persons.

shares are offered exclusively to foreign investors, and are denominated in RMB but purchased and sold in foreign currencies.[149] These kinds of shares are often called 'B' shares. Overseas listed shares refer to shares issued by Chinese joint-stock companies listed on securities markets outside mainland China.[150] At present there are H shares, N shares and L shares.[151]

At present, stock trading in China is mainly governed by the *Company Law* and the *Securities Law* . Stocks traded by parties to a stock transaction shall be the stocks issued and paid for in accordance with the law. Stocks that are not issued in accordance with the law shall not be traded.[152] Some stocks and company bonds may not be traded within a certain period of time.[153] The *Company Law* states that the transfer of shares and company debentures shall take place on securities trading places.[154] The *Securities Law* clearly specifies stock exchanges as the only places

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[149] According to *Regulations on Foreign Capital Shares Issued by Joint Stock Companies and Listed Domestically* promulgated by the State Council on December 25 1995, foreign investors include: foreign natural and legal persons and other foreign entities; Chinese natural and legal persons and other Chinese entities residing in Hong Kong, Macau, or Taiwan; Chinese citizens who are permanent residents of foreign countries; such other investors recognized by the SCSC (present CSRC).

[150] See, *Special Regulations on Foreign Person Shares Issued by Joint Stock Companies to be Floated and Listed overseas* (promulgate by the State Council on August 4, 1994), online :<http://www.csrc.gov.cn/CSRCSite/flfgk/> (date accessed: 20/01/2001).

[151] Those offered by Chinese companies listed on the Hong Kong Stock Exchange are called H shares; those on the New York Stock Exchange are N shares; those on the London Stock Exchange are called L shares. These alphabetic denominations will inevitably get longer. H shares are subscribed for and traded in Hong Kong Dollars, and denominated in RMB; N share are issued through ADRs (American Depository Receipts), and are subscribed for in US dollars and denominated in RMB; L shares are issued on the London Stock Exchange according to the Memorandum of understanding between relevant authorities of the UK and the PRC.

[152] *Supra* note 120 Art. 30.

[153] *Ibid.* Art. 31 states that: stocks, company bonds, and other securities issued in accordance with the law shall be subject to restrictions stipulated by the law on the allotted time for transfer. They shall not be traded within the restricted or allotted time period; *supra* note 82 Art. 147 states that promoters may not transfer their share in the company within three years after the establishment of the company. Directors, supervisors and the manager shall declare their shareholdings to the company and may not transfer such shares during their term of office.

[154] Supra 82 Arts. 144, 170.

designated to trade listed shares and company debentures.[155] However, this law fails to address the shares and debentures that are not listed on the two stock exchanges. Consequently, the trading of those unlisted shares and debentures in stock trading places other than the two stock exchanges should still be executed under relevant government regulations. The open and centralized price bidding method is adopted for the trading of shares in stock exchanges. The principle of price and time preference is practiced in this method.[156]

The present secondary stock markets comprise:

- SHSE and SZSE: according to the *Securities Law*, the stock exchange is a non-profit legal entity that provides a venue in which securities are collectively traded by bidding. The establishment and dissolution of a stock exchange is decided by the State Council.[157] The non-profit feature of the exchanges implies that they are to be considered a kind of self-regulatory membership organization. SHSE and SZSE are quite similar in forms of organizational structure and business scope. Both exchanges trade A shares, B shares, company debentures, and treasury bonds respectively.
- Securities Trading Automated Quotations System (STAQ system) and National Electronic Trading System (NET system): the STAQ system was launched in 1992 to provide a trading place for those state-owned enterprises which had been transformed into joint-stock companies to trade legal person shares. It is

[155] *Supra* 120 Art. 32, "Shares, company debentures, and other securities approved for listing and trading in accordance with the law shall be listed for trading in stock exchanges."
[156] *Ibid.* Art. 33.
[157] *Ibid.* Art. 95.

also used to trade treasury bonds. The STAQ system operates in a dealer market environment.[158] This system is run by a non-profit membership organization- the China Stock Exchange Council. The NET system was developed on the basis of the PBOC's VSAT satellite network and began to operate in 1993 trading state-owned legal person shares and treasury bonds. It is run by the China Securities Trading System Co., LTD (CSTC) jointly owned by the PBOC, ICBC and some other financial institutions engaging in short-term loan business transactions. The NET system practices centralized bidding by adopting an automated execution system.[159]

Regional Securities Exchanges (until March 1997 there were 27 regional securities trading centers all over China) have played certain roles in the growth of the China's securities market. However, with the promulgation of the *Securities Law* and the strengthening of centralized supervision, over-the-counter trading and local trading centers have been threatened with imminent cancellation.[160]

The issuance of shares and company debentures are subject to the examination and approval of the CSRC according to *Company Law* and *Securities Law*. To meet the overwhelming demands from companies to issue securities, China set up a quota system to allow orderly entry into the market. The quotas are set by the CSRC and

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[158] Arts. 8, 21 of *Provisional Regulations by the Stock Exchange Executive Council on Internal Negotiation and Assignment of Legal Person Shares* (issued on July 1, 1992), online: <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 21/01/2001).
[159] Art. 78 *Operating rules of China Securities Trading System Co., LTD* (adopted by the CSTC in 1993), online: <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 21/01/2001).
[160] Shi Tiantao, *ZhengQuanFaShiLun* (*Securities Law Construction*) (Beijing: Industry and Commerce Press, 1999) at 70.

then allocated to the local government and they enable the local government to put forward the listing candidates. Local governments have naturally tended to put forward the businesses they controlled, and those which needed money urgently, without giving sufficient thought to their future viability. Some people have commented that China's capital markets have been used by the Chinese government as an instrument to suck money from investors so as to enable state-owned enterprises to get out of their difficulties. With the maturity of China's stock markets, there will be more non-state owned enterprises listed. To be listed on one of China's two stock exchanges, a company shall meet the requirements of Article 152 of the *Company Law* [161], and therefore shall:

- have issued shares to the general public;
- have at least RMB 50 million in capital and at least 1,000 shareholders holding shares at a face value of more than RMB 1,000;
- have been in a position of making profits for the immediate past 3 years and possess no records of involvement in serious illegal activities or falsification of financial records;
- have shares issued to public accounting for 25% of the total shares.

ii) Futures Market

a) An Overview of the Development of the Futures Market

China's futures market is still in its infancy and is consequently characterized by a lack of adequate laws, excessive speculation, and frequent consolidation. In October 1990, the China Zhengzhou Grain Wholesale Market was established with the

[161] *Supra* note 82.

assistance of the Chicago Board of Trade. On May 28, 1993 it was transformed into the Zhengzhou Commodity Exchange - the first official agricultural commodity futures exchange in China. After this, many Chinese cities began to follow suit. Futures exchanges sprouted across China overnight trading more than fifty commodities. In mid 1994, there were over 60 futures exchanges and 500 futures trading brokerage houses in China.[162] With the rapid expansion of the futures market, speculation, even fraudulent behavior became rampant. To end the blind proliferation of the future market, the State Council and relevant authorities began to crack down illegal operations in the futures market. On May 16, 1994, the SCSC submitted to the State Council its *Opinion on Stopping the Blind Proliferation of the Futures Market*. The State Council approved the SCSC's proposal to narrow the scope of futures trade and reduce the number of futures brokerages and futures exchanges. Through consolidation, the number of futures exchanges was reduced from over 60 to 15 and the brokerages were decreased to 170. Futures contracts on 20 major commodities such as steel, coal, and gasoline were banned.[163] After the Asia Financial Crisis of 1997, the Chinese government took measures to consolidate the futures market and further reduced futures exchanges from 14 to 3, namely, the Zhenzhou Futures Exchange, the Shanghai Futures Exchange and the Dalian Futures Exchange.[164] The futures trade was primarily restricted to green beans, soybeans, copper, aluminum, wheat and natural latex.[165] The trading

[162] Chengxi Yao, *supra* 144 at 112-113.
[163] "China Futures Market to Stay Low Key" *Reuter Far East* (16/01/1995) 5.
[164] "Shanghai Futures Exchange Formally Founded" *Zhengquan Shibao[Securities time translated, by the autho]* (20/12/1999) 2.
[165] "China's Futures Contract Volume Down in 1998" *Qihuo Ribao [Futures Daily, translated by the author]* (28/01/1999) 2.

volumes in the three futures exchanges were RMB 2.5 trillion in 1999.[166]

Before the '327 Event,'[167] T-bond futures contracts had also developed in China. By1994, T-bond futures contracts were traded in all major securities and commodity markets in China. The definition of T-bond futures contracts is as follows: it is a contract with treasury bond futures as its contractual object. The delivery of T-bond futures involves the passage of ownership of the treasury bond. Thus, delivery may be effected in either of two modes: delivery of the T-bond in paper form, and delivery of the T-bond in paperless form. In each case, cash settlement is prohibited.[168] After the "327 Event", T-bonds were banned on China's domestic market.

b) Regulatory Structure of the Futures Market

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[166]"Conditions Ripe for Launching Future Index in China" *Touzi Yu Hezuo [Investment & Cooperation, translated by the autho]* (Feb 2000). This article also pointed out that futures brokerages have been on the decline for three successive years and the futures trading volume in the three futures exchanges was RMB 3.7448 trillion in 1997 and 3.2986 trillion in 1998 and it attributes this situation to the lack of futures products.

[167] '327 Event' refers to scandal that occurred in China's financial market on Feb. 23, 1995 and was named after the contract No. concerning Shanghai International Securities Co., LTD (SISCO), which was betting on a declining market in futures contracts concerning the 1992 three-year T-bond that would mature in June 1995. Based on the declining inflation rate in China and a possible issuing of RMB 150 billion T-bonds, they built a short position on T-bond futures Contract No. 327. A decision by the Ministry of Finance to shelve 2/3 of the planned bond issue and some other heavy players' switching from short to long positions caused the price rise promptly. SISCO soon found itself surrounded by soaring losses. Just eight minutes before the bell, SISCO drove down the price by shorting a massive RMB 250 billion worth of T-bonds on some 11 million contracts, which was twenty times more that it was allowed and was mostly for its own proprietary account. Two days later the Ministry of Finance announced an inflation subsidy rate for the 1992 three-year T-bonds, and raised their initial coupon rate of 9.5% to 10.38%. SISCO's losses from its short positions were estimated by some Western source to be more than US$ 120 million. See "China Blames Two Firms for Bonds Scandal" *Financial Times* (22/09/1995).

[168] Arts.2, 25, 26, *Provisional Regulations on T-bond Futures Trading* (issued jointly by CSRC and the Ministry of Finance on 23/02 1995), online: <http://www.csrc.gov.cn/CSRCSit/flfgk> (date accessed: 23/01/2001).

China's futures market had developed without any national legislative intervention until, on April 28, 1993, the State administration of Industry and Commerce (SAIC) used its authority to claim that futures brokerages shall register with it in the same way as other enterprises according to the *Regulations on Registration of Legal Person Enterprises*.[169] The SCSC and the CSRC were empowered by the State Council to supervise the futures brokerages and the futures exchanges at the end of 1993. In March 1995, the State Council formally approved the organizational plan of the CSRC, thereby confirming CSRC to be a deputy-ministry rank unit directly under the State Council and the executive branch of the SCSC. The CSRC was authorized to conduct the supervision and regulation of the futures markets in China. *The Provisional Regulations on Administration of the Futures Trade*[170] issued in 1999 states that the CSRC will conduct centralized supervision and regulation over the futures market in China.

The Provisional Regulations on Administration of the Futures Trade consolidated the fragmented opinions, and regulations issued before 1999 and established a more unified administration framework over the futures market. These regulations define futures exchanges as non-profit organizations approved by the CSRC and it specifies that its members shall be legal person enterprises legally registered within the PRC. The members will be comprised of futures brokerage houses and non-futures brokerage companies. Futures trading shall be conducted in futures

[169] Chengxi Yao, *supra* note144 at 112.
[170] *The Provisional Regulation on Administration of Futures Trade* (issued by the CSRC in 1999), online: <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 25/01/2001).

exchanges.[171] To engage in futures brokerage business, futures brokerage houses are required to obtain a license from the CSRC and to register with the SAIC. The minimum registered capital requirement for futures brokerage houses is RMB 30 million. Future brokerage houses shall not engage in any business other than the buying and selling, and settlement and delivery of futures as listed in the futures exchanges. They are prohibited from engaging, either overtly or covertly, in futures proprietary business.[172] The method of centralized price bidding and the principle of price and time preference shall be adopted in futures trading.[173] Only the members of the futures exchanges can engage in futures trade in futures exchanges. Futures brokerage houses are restricted to futures brokerage business and non-brokerage members are restricted to proprietary business. Financial institutions, administrative organizations and state offices and staffs of the CSRC are prohibited from engaging in futures trading; futures brokerage houses are prohibited from acting as agents of the above mentioned entities in futures trading. State owned enterprises or enterprises in which state assets constitute a holding position are restricted to futures trading for hedging purposes only. Moreover, the guarantee deposit system shall be adopted in futures trading and futures brokerages are forbidden from oversea futures trading.[174]

iii) Money Market

a) *An Overview of the Money Market*

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[171] *Ibid.* Arts 4, 6, 7, 8.
[172] *Ibid.* Arts 21, 22, 25.
[173] *Ibid.* Art 39
[174] *Ibid.* Art.28, 30, 39, 48.

The money market is generally defined to include all financial instruments such as debt instruments with maturity of less than one year that can be easily converted to means of payment. The money market provides the market participants with short-term liquidity and the central bank with tools of monetary policy.[175] The money market in China is still in its infancy, since it first emerged in China a few years after China's economic reform. The present money markets in China mainly consist of the inter-bank market, the repurchase agreement market and the commercial paper market.

1) Inter-bank Market

The notion of the inter-bank market was essentially foreign to the pre-1979 Chinese mono-bank system, in which no inter-bank borrowing or lending was necessary since the liquidity needed by the bank branches could be provided by the State Council through the PBOC, and extra cash was channeled to the government. With the divestiture of the PBOC and the establishment of the specialized banks and other financial institutions, the financing of enterprises' working capital was shifted from government departments to specialized banks and a reserve requirement was mandated for those banks. Consequently, these banks began to feel the need for an inter-bank market to cover short-term cover positions.[176] In 1983, as an experiment, a branch of the ABC in the coastal city of Wenzhou created an unofficial inter-bank market by allowing its sub-branches to borrow from each other and the branches of other banks followed suit in the city. The tight monetary policy of the PBOC in

[175] Hong Chang et al., "Money Market in China" in Baizhu Chen et al., eds., *supra* note 57 at 171.
[176] Eric Girardin, *supra* 90 at 77-78.

1985, which resulted in a severe fund shortage in some regions and an excess in others, gave some impetus to the spreading of the inter-banks market. By the end of 1987, they proliferated in nearly all regions of China.[177] While the inter-bank market was experiencing phenomenal growth, lack of proper regulation and supervision was increasingly becoming a problem. Unauthorized activities were also common. A host of funds flowed from the inter-bank into fixed assets investment through finance companies. Faced with this situation, the PBOC issued a series of regulations to curb irregularities in the inter-bank markets. The participation of non-bank financial institutions was limited; the reference rate of inter-bank loan was introduced and the six main regional inter-bank markets were created.[178] As the economy of China heated up in 1992 with the "south tour talks of Deng Xiaoping," the inter-banks markets also grew steadily and the trading volume reached RMB 10, 000 million in 1995.[179] However the markets were still segmented with the different interest rates and different maturity rates of inter-bank loans in different regions. Such segmentation encouraged irregularities in the inter-bank market and hindered its development. In 1996, the PBOC finally unified the segmented markets into a national market, comprised of inter-connected primary networks and secondary networks.[180] The Asia financial crisis made China's government more determined to prevent bank funds from illegally flowing into the

[177] Hassanali Mehran et al., *Monetary and Exchange System Reforms in China – an experiment in gradualism* (Washington D.C: International Monetary Fund, c1996) at 24.
[178] Eric Girardin, *supra* 90 at 78.
[179] Hong Chang et al., "Money Market in China" in Baizhu Chen et al., eds., supra note 57 at 177.
[180] See *ibid.* 15 commercial bank headquarters approved by the PBOC, 35 financing centers correlated to the original PBOC provincial branches constitute the main players in the primary market. The China Foreign Exchange Trade System is employed to conduct inter-bank transactions. Commercial bank branches, and sub-branches authorized by their head offices and local financial institutions are the participants of the secondary network.

stock market. In 1997, securities firms and other non-bank financial institutions were excluded from the inter-bank markets. Meanwhile, the Ministry of Finance stopped issuing government bonds through the stock exchange. At this point, the inter-bank participants were mostly capital suppliers – commercial banks. Consequently, the inter-bank market became inactive and the trade volume in the nation wide inter-bank market was RMB 90 billion in 1998.[181] Such a situation in the inter-bank market was unfavorable to permit the PBOC to develop a currency market. Consequently, beginning at the end of 1998, the PBOC issued a series of regulations to allow insurance companies, the RCCs, Securities firms, fund management companies, financial companies, and foreign financial institutions providing RMB services to enter the inter-bank market.[182]

2) Repurchase Agreement

A repurchase agreement is an acquisition of funds through the sale of securities, with a simultaneous agreement by the seller to purchase them at a pre-negotiated price at a later date.[183] They are actually guaranteed borrowing of short-term funds using underlying securities as collateral. The repurchase agreement market emerged in China in 1991 with the establishment of the SHSE and the STAQ system. Two kinds of transaction, namely "on site" trading and "off site" trading are applied in

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[181] Yuan Dong, "China's Securities Firms May now Enter Inter-bank Market" *Zhengquan Shichang Zhoukan [Stock Market Weekly,translated by the author]* (September 1999) at 6.
[182] "The PBOC allows financial companies to join money market" *Jinrong Shibao[Financial News, translated by the author]* (06/09/2000) 1.
[183] Hong Cheng et al., "Money Market in China" in Baizhu Chen et al., eds., *supra* note 57 at 182.

the repurchase agreement market.[184] Segmentation has affected the development of the repurchase agreement market. The PBOC is now formulating new measures for the operation and management of inter-bank bond trading and the repurchase agreement purported to unify the market and enlarge the membership of this market.[185]

3) Commercial Papers Market

Commercial paper is a short-term unsecured promissory note that is generally sold by large corporations on a discount basis to finance short-term working capital quickly.[186] The commercial papers market is still underdeveloped although it first emerged in the early 1980s. Before the promulgation of the *Instruments Law of the PRC* in 1995, this market was governed by certain regulations of an expedient nature. However, the passing of the *Instruments Law*[187] did not give much impetus to the growth of the commercial papers market given the difficulty of enforcing the punishment against those who could not honor their commercial papers.[188] The ulterior reason for the meager size of this market lies in the non-transparent

[184] See *ibid.* The "on site" trading used the stock exchange or STAQ for payment and clearance; the "off site" trading completed payment and clearance within the trading centers without going through the exchange or STAQ.

[185] "New Regulations for Bond Trading" *Zhengquan Shibao [Securities Times, translated by the author]* (26/04/2000) 3.

[186] Hong Cheng et al., "Money Market in China" in Baizhu Chen et al., eds., *supra* note 57 at 187.

[187] *Negotiable Instruments Law of the PRC* (adopted at the 13th Meeting of the Standing Committee of the 8th NPC on 10/05/1995 and effective as of 01/01/1996), Handbook of Foreign Economic Law (Beijing: Publish House of Law, 1997) at 929-965. [hereinafter *Instruments Law*].

[188] *Ibid.* Art. 103 mainly deals with instruments frauds such as the forgery of instruments, but failure to honor can seldom be ranged among such criminal violations; Art. 106 states that if a payer intentionally delays paying an instrument payable on sight or having reached maturity, the financial administration department shall fine the payer and punish any personnel directly responsible. If the payer's intentional delay in payment causes losses to the bearer the payer shall be liable for compensation according to law. However, first, 'intentional' is a very elastic term in reality; second, the enforcement rate of economic cases is generally under 40%.

accounting system that hinders accurate risk assessment and the growth of credit rating agencies.[189]

b) The Regulatory Framework

The legal framework of the money market is characterized by some incoherent regulations, each issued as expedients to deal with specific problems.

To correct the irregularities in the money market, the PBOC issued its "Provisional Measures on the Management of Inter-bank Markets" in 1990. This specifies some of its operating principles:

- inter-bank activities shall be based on the principle of voluntariness;
- prohibition of funds from inter-bank markets used to finance fixed-asset loans;
- the funds borrowed shall not exceed levels which would endanger solvency ratios and the banks' daily borrowing limit is 5 percent of the deposit collected at the end of the last month. The daily ceiling for non-bank financial institutions shall be decided by their own capital;
- based on the supply and demand of funds the PBOC sets the ceiling on the interest rate. It is generally 0.3 points higher than the PBOC's rates for daily lending to state banks;
- both principals and interests shall be paid through accounts;
- The PBOC performs audits and statistical analyses on a regular basis.

The *Commercial Bank Law* of 1995 only touches the inter-bank market in one article. Article 46 states that inter-bank loans shall be made in accordance with the terms set

[189] Hong Cheng et al., "Money Market in China" in Baizhu Chen et al., eds., *supra* note 57 at 188.

by the PBOC, and the longest term shall not exceed 4 months. It is forbidden to use borrowed inter-bank funds to issue fixed assets loans or to make investments. Funds for inter-bank loans shall be restricted to idle funds after fully paying the deposit reserve funds, standing funds and mature loans to the PBOC. Funds borrowed from the inter-bank market shall be used for making up shortfalls in the settlement of accounts, shortages in inter-bank balances and the need for temporary working funds.

In 1999 the PBOC felt the need to enlarge its membership in the money market so as to boost activities in this market. It consequently issued three regulations, namely, *Regulations on Administration of Securities Firms' Entry into the Inter-bank Market,*[190] *Regulations on Administration of Fund Management Companies' Entry into the Inter-bank Market,* [191]and *Regulations on the Administration of Financial Companies' Entry into the Inter-bank Market.*[192] According to these regulations, a securities firm's borrowing time is limited to seven days and the time limit on the repurchasing agreement is one year; fund management companies are allowed to conduct securities repurchase agreement transactions that bear a time limit of one year in the inter-bank market; financial companies, which were once expelled from this market in 1989, can enter this market should they satisfy certain

[190] *Regulations on Administration on Securities Firms Entry into the Inter-bank Market* (issued by the PBOC on 19/08/1999), online at <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 27/01/2001).
[191] *Regulations on Administration of Fund Management Companies Entry into the Inter-bank Market* (issued by the PBOC on 19/08/1999), online at: <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 27/01/2001).
[192] *Regulations on the Administration of Financial Companies Entry into the Inter-bank Market* (issued by the PBOC on 19/08/1999, online at: <http://www.csrc.gov.cn/CSRCSite/flfgk> (date accessed: 27/01/2001).

conditions.[193] At present the participants in the money markets include commercial banks, insurance companies, foreign invested banks that are allowed to do RMB business, RCCs, securities firms, fund management companies and financial companies.

II. FOREIGN PARTICIPATION IN CHINA'S FINANCIAL MARKETS BEFORE CHINA'S ACCESS TO WTO

The Chinese government has been very conservative and cautious in opening up its financial market. However, after over 20 years of reform, there are already quite a number of foreign financial institutions participating in China's financial market in a variety of ways.

A. Foreign Participation in Banking Sector

i) Types of Foreign Participation

Ever since the inception of China's economic reforms in 1978, foreign financial institutions have been striving to establish footholds in China's banking sector. Though China's top leaders are divided on the issue of opening up financial sectors to foreign investors, they finally decided to introduce some foreign banks in this sector as a source of foreign capital and banking management experience. In 1979, a Japanese bank – the Export and Import Bank of Japan gained entry into this sector

[193] These conditions include: debt-to-asset ratio meets the relevant PBOC standards; profitable for the last 3 consecutive years; sound internal control system; never been punished by the PBOC or other supervisory departments for irregular operations.

through establishing a representative office in Beijing.[194] Three years later the Hong Kong based Nanyang Commercial Bank was permitted to open its branch in the Shenzhen economic zone.[195] Over the years, through concerted efforts, foreign banks have gained a considerable presence in this sector. By the end of March 2000, foreign banks in China held assets totaling US$ 31 billion, representing 2 percent of the total assets of china's financial sector.[196] Their total foreign currency loan amounted to US$21 billion, accounting for 20% of the total within China. Among the 182 business operations in China's banking sector, 32 foreign banks and branches are currently permitted to engage in RMB business.[197] Foreign banks usually establish their presence through one of the following organizational forms:

1) Representative offices: they serve as points of contact for the provision of marketing information and the establishment of business connections. Representative offices are prohibited from undertaking any banking activities such as deposit taking and lending;[198]
2) Foreign branches: these constitute the legal extension of the parent banks. Foreign branches can usually offer the full range of banking services permitted by Chinese laws and regulations. At present a majority of foreign banks have selected this form of presence and among the 182 foreign banking institutions, 169 were bank branches;[199]

[194] Ji Chen and Stephen C. Thomas, "Banking on China"(1999), online: China Business Review <http://www.chinabusinessreview.com/9911/chen.html> (date accessed: 12/09/2000).
[195] *Ibid.*
[196] See "Are Chinese Banks Ready for Competition?" *Jingji Ribao [Economic Daily, translated by the author]* (12/05/2000) 4.
[197] *Ibid.*
[198] Francis A. Lees and K. Thomas Liaw, *supra* note 72 at 32.
[199] See the PBOC Statistics (2000), online: <http://www.pbc.gov.cn/trsweb/Detail> (date accessed: 29/01/2001).

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3) Wholly foreign invested banks and joint-venture banks: they are Chinese legal persons incorporated according to Chinese laws and regulations and they can conduct all the banking activities approved by the PBOC. At present there are 6 wholly foreign- owned banks and 7 joint-venture banks.[200]
4) Equity participation in China's commercial banks: so far such channels have only occurred on a case by case basis.[201]

ii) Legal Framework regarding Foreign Participation in Banking Sector

From the emergence of the first representative office in 1979 to the issuance of the *Measures for the Administration of the Establishment of Resident Representative Offices in China by Foreign Financial Institutions* [202]by the PBOC, foreign representative offices were governed by certain regional and provisional regulations. With more and more representative offices established, some began discounting trade bills and confirming letters of credit, and the PBOC felt it was high time to standardize practice in this field. On June 11, 1991, the PBOC issued the *Representative Office Procedure*. This states that foreign representative offices in China shall be limited to non-profit activities such as consultancy, liaison, and market research. They may not undertake profit-making activities on behalf of their

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[200] Ji Chen and Stephen C. Thomas, *supra* note 194.

[201] In 1997 the Asian Development Bank purchased a 3.3% stake in China Everbright Bank and the International Finance Corporation purchased a 5% stake in the Shanghai City United Bank. At present only 3 Chinese banks have issued A shares on the stock exchanges, but they are not accessible to foreign individuals or legal persons. With the possible emerging of A shares and B shares, and more banks going public, this channel may be enhanced.

[202] *Measures for the Administration of the Establishment of Resident Representative Offices in China by Foreign Financial Institutions* (issued by the PBOC on 11/07/1991) in English and Chinese in *Hand Book of Foreign Economic Law* (Beijing: Publishing House of Law, 1997) at 1097-1106.[hereinafter *Representative Office Procedures*]

head offices.[203] The PBOC is responsible for the examination and approval of the establishment of representative offices.[204] *The Representative Office Procedures* empowered the PBOC and its branches to supervise, regulate and examine the work of these offices.[205] The representative offices are required to submit an annual report on their activities during the previous year to the PBOC and its branches.[206] If a foreign bank seeks to close a representative office, it must apply to the PBOC and undergo a de-registration process.[207] For most foreign institutions, representative offices are just a transitional structure prior to the establishment of branches or banks.

After the Nanyang Commercial Bank was permitted to set up branches, many other foreign banks were also allowed to set up branches and foreign invested banks in China's five Special Economic Zones and in Shanghai. During this period, the State Council and the PBOC issued their own regulations, respectively, applicable to the Special Economic Zones and Shanghai.[208] The State Council promulgated *The Regulations for the Administration of Foreign Investment Financial Institutions*[209]

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[203] *Ibid.* Art.8.
[204] *Ibid.* Art. 6.
[205] *Ibid.* Art. 16.
[206] *Ibid.* Art 14, for those offices in Beijing, they are required to send their reports to the head office of the PBOC; for those offices outside Beijing, they are required to send their reports to corresponding branches of PBOC.
[207] *Ibid.* Art. 15, its head office shall bear responsibility for any unsettled matters the resident representative office is involved in.
[208] *The Regulations for the Administration of Foreign Investment Banks and Sino-Foreign Joint Venture Banks in Special Economic Zones* (promulgated by the State Council on April 2, 1985); *The Directive on Procedures for the Administration of Foreign Investment Financial Institutions and Sino-Foreign Joint-Venture Financial Institutions in Shanghai* (issued by the PBOC on September 8, 1990) in English and Chinese in *Handbook of Foreign Economic Law* (Beijing: Publishing House of Law, 1997).
[209] *The Regulations for the Administration of Foreign Investment Financial Institutions* (promulgated by Decree No. 148 of the State Council on PRC on 25/02/1994) in English and Chinese in *Handbook*

on February 25, 1994, which superseded the two previous regulations. On April 30, 1996 the State Council issued its *Detailed Rules for the Implementation of the Regulations for the Administration of Foreign Investment Financial Institution[hereinafter Detailed Implementation Rules]*. According to the *Financial Institution Regulations*, financial institutions are said to comprise: branches of foreign banks, wholly-foreign invested banks with head offices within China, Sino-foreign joint ventures banks, foreign invested financial companies with head offices within China, and Sino-foreign joint venture financial companies.[210]

To establish a foreign financial institution, the applicant must satisfy the following requirements:

- A foreign financial institution wishing to establish either a branch, or a foreign investment bank or a joint venture bank must have maintained a representative office in China. The minimum time for branches and foreign investment banks is two years; no minimum time is specified for the foreign party of the joint venture banks. The minimum two–year requirement serves as a kind of 'probation' period, during which the PBOC can assess their 'conduct' and the possibility of upgrading the offices to branches two years later.
- minimum assets and capital requirement: the branch of a foreign bank must have a sum of freely convertible currencies equivalent to RMB 100 million allocated from its head office as working capital, and the parent bank must possess no less than US$ 20 billion at the end of the year prior to such

of Foreign Economic Law (Beijing: Publishing House of Law, 1997) at 1057-1077.[hereinafter *Financial Institutions Regulations*] application; a foreign investment or a joint venture bank must have freely convertible currencies equivalent to RMB 300 million as registered capital (at least 50% paid up) and its parent bank must possess no less than US$ 10 billion at the end of the year prior to such application.[211]

- Industry limitation: for foreign investment banks, the applicants must be financial institutions; for joint venture banks, both parties must be financial institutions.

According to the *Financial Institution Regulations* and the *Detailed Implementation Rules* thereof, the business scope of a foreign investment bank, a foreign bank branch or a joint venture bank may comprise the following:

- foreign exchange deposits;
- foreign exchange lending;
- foreign exchange note discounts;
- approved foreign exchange investments;
- foreign exchange remittance into and out of China by foreign investment enterprises, foreign nationals and overseas Chinese in China;
- foreign exchange guarantees;
- import and export clearing;
- trading in foreign exchanges for its own account and for clients;
- acting as an agent for the exchange of foreign currencies and foreign exchange notes;

[210] *Ibid.* Art. 2.
[211] *Ibid.* Arts 5-7.

- acting as an agent for foreign currency credit card payments;
- custody and safe deposit box services;
- credit investigation and advice;
- Approved domestic currency business and other approved foreign currency business.[212]

The ultimate goal of these foreign banks is to operate RMB business. When China liberalized its RMB current account in December 1996, it also approved 8 foreign banks and branches to take RMB deposits on a trial basis in the Pudong Development Area of Shanghai. In 1998 the PBOC approved more foreign banks and branches to do RMB business in Pudong and made Shenzhen the second city where approved foreign banks and branches can take RMB deposits. In the same year, 8 foreign banks and branches gained entry into China's inter-bank market engaging in borrowing and lending, and the bond repurchase business. Foreign financial institutions now operating in Shanghai and Shenzhen can apply for RMB business if they meet the following requirements:[213]

- operation in China for over 3 years and a two-year consecutive profit making record prior to their submission of application;
- the branches of foreign banks in China must have an average month-end foreign currency loan balance of more than US$ 150 million within China. Foreign wholly-owned or joint venture banks must have an average month-end foreign currency loan balance of more than US$ 100 million;

[212] *Ibid.* Art. 17

- Their total foreign currency loan balance with China must make up at least 50 percent of their total foreign currency assets.

The PBOC issued a Circular in July 1999, which expanded the role of foreign banks in China. Geographic restriction on foreign banks engaging in foreign currency was lifted and geographic restriction on foreign banks approved to conduct RMB business was relaxed. Foreign banks engaging in RMB business in Shenzhen could expand their RMB business to Guangdong Province, Guangxi Autonomous Region and Hunan Province; those engaging in RMB business in Shanghai could expand their RMB business to Jiangsu Province and Zhejiang Province. This Circular raised the RMB lending level of the foreign banks approved for RMB business from 35 to 50 percent of total RMB deposits. RMB funds over one year were also made available to foreign banks.[214] With the up-coming access to the WTO, China has accelerated the speed of liberalization in its banking sector.

B. Foreign Participation in the Insurance Sector

i) Types of Foreign Participation

The potential of China's insurance market, coupled with the relative lack of local experts, have led to the world's leading insurance companies queuing up to start operations in China. However, the Chinese government has been very cautious in opening up its insurance sector. Before 1992 when the PBOC granted the first

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[213]See "Interview with Tang Shuangning, Chief of Banking Regulatory Department of the PBOC" *Jinrong Shibao [Financial News, translated by the author]* (12/05/2000) 2.
[214]"China's Banking Reform and WTO" (1999), online: <http://www.tdctrade.com/econforum/sc/991203.htm> (date accessed: 02/04/2001).

license to open an insurance branch in Shanghai to the American International Group, Inc (AIG), the only entry form for foreign insurers was to set up representative offices in China.[215] The AIG was licensed to underwrite both life and property insurance in Shanghai. Tokio Marine & Fire of Japan became the second foreign insurance company approved to undertake property insurance in Shanghai in 1994. In 1995 Guangzhou became the second city where foreign insurance companies could establish branches upon approval of the PBOC. The AIG obtained two licenses to underwrite, respectively, life and property in Guangzhou that year. The Manufacturers Life and Insurance Co. of Canada set up the first joint venture with China Chemicals Import and Export Corporation (Sinochem) in 1996. It began its life insurance operation in Shanghai at the end of 1996.[216] The liberalization in this sector has been proceeding slowly since 1995 at a pace of 2-3 licenses per year. The Chinese government sweetened the bilateral trade agreement with the EC concluded May 2000 with the offer of seven licenses to insurers from the EC, and ING Insurance of the Netherlands and Assicurazioni Generali of Italy became the two lucky recipients in June 2000 out of the promised list of seven licenses. By July of 2000, the Chinese government had allowed 17 insurance companies from US, Britain, Japan, Canada, Switzerland, Germany, France, Australia, and the Netherlands to enter its insurance market.[217] In the hopes of eventually obtaining a license, 113 foreign insurance institutions from 17 countries have opened 202 representative offices in China. By the end of 1999, foreign-funded insurance

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[215] Xiaohong Wu and Roger Strange, "The Insurance Industry in China – The experience of European, US and Japanese Firms", in Roger Strange et al., eds., *Trade and Investment in China* (New York, N.Y: Routledge, 1998) at 247-248.
[216] *Ibid.* at 49.

companies in China had total assets of RMB 4.4 billion (US$ 532 million), accounting for 1.7% of the total of China's insurance industry. Sales of insurance premiums reached RMB 1.82 billion representing, 1.3% of China's total.[218] At present foreign insurance institutions participate in China's insurance sector through the following means:

- representative offices: these are limited to liaison-type activities of a non-profit making nature;
- branches of foreign insurance companies: foreign insurers can apply to set up branches in Shanghai and Guangzhou to undertake property insurance. The AIG is a special case, it was approved to issue both life and property insurance in Shanghai, and life insurance in Guangzhou, through branches set up in the two cities;
- joint venture insurance companies: foreign insurers can apply to set up joint insurance companies with a Chinese party to undertake life insurance. The foreign party is allowed to have up to 51% equity;
- Equity participation in China's domestic insurance companies: at present a single foreign investor is allowed to hold a maximum 5% stake in a domestic insurance company and the aggregate of foreign investors shall not exceed 25%.[219] For example, the Zurich Insurance Co., Japan's Meiji Life Insurance Co. and some other 3 firms will each hold a 4.9% stake of the Xinhua Life

[217] See the CIRC Statistics (2000), online: the CIRC homepage <http://www.circ.gov.cn/tjsj/tjsj.htm> (date accessed: 03/04/2001).
[218] *Ibid.*
[219] The CIRC was considering raising the 5% maximum stake of a foreign investor to 10%. See *Jingji Cankao Bao [Economic Information Daily, translated by the author]* (25/04/2000).

Insurance Co.[220] Japan First Life and Lincoln National Corp. of the US have each been approved to purchase up to 5% of Ping An Insurance Co. of China.[221]

ii) Legal Framework regarding Foreign Involvement in the Insurance Sector

The *Representative Office Procedure* also applies to insurance companies.[222] When Shanghai was selected as the first city to allow foreign insurers to engage in insurance business in 1992, *Shanghai Administrative Measures for Foreign Investment Companies*[223] was also issued by the PBOC late that year. The *Shanghai Measures* delineated the entry requirement as follows:

- the maintenance of a representative office in China for 3 years;
- prior engagement in the insurance business for over 30 years;
- assets of no less than US$ 8 billion at the end of the year before its application;
- constitution in the form of a joint venture or a branch.

China's *Insurance Law* was the first ever unified insurance law in the history of the PRC. It absorbed certain internationally accepted insurance principles and spelled out the basic legal structure of insurance companies, insurance contracts, as well as international rules guiding company operations. It also established the separate operation of property and life insurance as a principle.[224] However, the *Insurance*

[220] "China Weekly Business Report" *Interfax* Issue # 0014 (September 1, 2000), online: <http://www.interfax-news.com> (date accessed: 05/04/2001).
[221] Ji Chen and Stephen C. Thomas, "At Premium", online: <http://www.chinabusinessreview.com/9903/thomas.html> (date accessed: 07/04/2001).
[222] *Supra* note 209 Art 2 states that foreign financial institutions mentioned in this procedure refer to foreign capital banks, securities firms, investment companies, insurance companies, financial companies, credit card companies and financial leasing companies.
[223] *Shanghai Administrative Measures for Foreign Investment Companies* (issued by the PBOC in November 1992) in Chinese and English in *Handbook of Foreign Economic Law* (Beijing: Publishing House of Law, 1997)[hereinafter *Shanghai Meaures*].
[224] Xiaohong Wu and Roger Strange, "The Insurance Industry in China – the experience of European, US and Japanese Firms" in Rogers Strange et al., eds., *supra* 215 at 245.

Law contains no clause to deal with foreign participation in the insurance sector. In July 1996 the PBOC issued *Provisional Regulations for Administration of Insurance*[225] as supplementary rules of the *Insurance Law*. This states that the *Insurance Law* applies to the establishment of a foreign investment insurance company and branches of foreign insurance companies within China.[226] The *Insurance Supplementary Rules* actually lowered the entry requirement for foreign insurers. The minimum operation time of a representative office was reduced to 2 years and the assets requirement was lowered to US$ 5 billion and the business location was extended to Guangzhou.[227] In 1998, Shenzhen became the third city where foreign insurers could apply to conduct insurance businesses. The CIRC replaced the PBOC and became the sole regulator of insurance industry in 1998. The CIRC issued a detailed *Regulations on Administration of Insurance Companies* according to the *Insurance Law* of 1995 at the beginning of 2000. This regulation is applicable to foreign investment insurance companies except in so far as they are otherwise regulated by other laws, regulations or other situations that are specified by the CIRC.[228] Therefore, the *Shanghai Measures*, which was revised according to the basic principles of the *Insurance Law*, are still considered the principal legal framework for the regulation of insurance institutions with foreign investment. There are some restrictions on the business scope of the foreign insurers besides the geographic restriction. Foreign insurers in China may sell property insurance only

[225] *Provisional Regulations for Administration of Insurance* (issued by the PBOC in July 1996) in both Chinese and English in the *Handbook of Foreign Economic Law* (Beijing: Publishing House of Law, 1997).[hereinafter Insurance Supplementary Rules].
[226] *Ibid.* Art. 148.
[227] *Ibid.* Art. 11
[228] Supra note 133 Art. 150.

to foreign-investment companies and may sell life insurance only to foreigners or individual Chinese persons in China.

C. Foreign Participation In China's Securities Markets

i) Foreign Participation in Securities Sector

Compared with the banking and insurance sectors, China's securities markets are considerably more closed to foreign participation. On the one hand, securities markets have been associated with the sensitive ideological topic of socialist state ownership; on the other hand, China's stock market is only ten years old and Chinese securities companies are still too immature to handle a full-scale opening in a short period of time.[229] However, because of the great potential in China's securities market, as early as 1982, the Nomura SEC Co. LTD – a Japanese securities firm - set up its representative office in Beijing. Morgan Stanley Dean Witter Asia LTD established its representative office in Beijing in 1993. By the end of 2000, securities firms from France, Korea, the Netherlands, the US, Japan, Switzerland, Taiwan, Hong Kong, Singapore, the UK had set up 61 representative offices in the cities of Beijing, Shanghai and Shenzen in China.[230]

China's stock markets are connected with international capital markets by means of issuing B shares to foreigners and listing domestic companies at overseas stock

[229] There were 97 professional securities companies with total assets of RMB 159 billion (US$ 19.2 billion) in China by the end of 1999. On average, each company had just under RMB 1.7 billion (US$ 205 million) in assets. But in the US at the end of 1997, there were almost 10,000 securities companies with over 60,000 branches. The total assets topped US$ 2 trillion and their pre-tax profits reached US$ 12 billion. The assets of a large overseas investment bank are 100-200 times those of a large Chinese securities company. See the CSRC Statistics online: < http://www.csrc.gov.cn/CSRCSite/zjjg/wzzqjgdbc.htm>. (date accessed: 11/04/2001).

markets. By the end of 2000, there were 114 stocks listed on the B share markets in Shanghai and Shenzhen, and over a hundred foreign securities dealers were participating directly in B shares trading there. Some internationally esteemed securities firms such as Merrill Lynch, Nomura, and Jardine Fleming have dedicated seats at the SHSE, and many securities firms participate in the IPO of some Chinese companies at overseas stock markets. For example, Merrill Lynch, Morgan Stanley Dean Witter & Co. and China International Capital Corp. (CICC) have won the coveted role of underwriting China Telecom's July 2001 overseas listing plan. China Telecom, China's dominant fixed-line operator plans to raise between US$ 8 billion and 10 billion through an IPO on Hong Hong's main board and the New York Stock Exchange. The fees from the IPO could reach US$ 300 million based on the usual 3% underwriting fees.[231] International debt financing activities of the Chinese government, financial institutions and some enterprises have provided additional opportunities for some international securities firms such as Nomura, Goldman Sachs and Merrill Lynch.

Up to now, there has only been one joint venture firm engaging in investment banking business in China. Back in 1995, Morgan Stanley (now Morgan Stanley Dean Witter) set up the China International Capital Corp (CICC) with the China Construction Bank.[232] Since its establishment, the CICC has led or participated in

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[230] *Ibid.*

[231] See "Four Trends in The Development of China's Securities industries" *Zhengquan Shibao [securities Times, translated by the author]* (December 29, 2000) 6.

[232] The CCB holds 42.5% of the equity, Morgan Stanley 35%; China National Investment & Guaranty Corporation, the Government of Singapore Investment Corporation and the Mingly Corporation Limited (Hong Kong) each holds 7.5%, see onlin: the CICC < http://www.cicc.com.cn> (date accessed:12/04/2001).

many significant oversea listing of Chinese enterprises. In 1997 it led the successful US$ 4.2 billion dual listing of China Telecom (Hong Kong) LTD on the Hong Kong and New York Exchanges. In 2000, the CICC completed the dual listings of PetroChina and Unicom on the Hong Kong and New York exchanges, raising US$ 2.9 billion and US$ 5.7 billion, respectively, for the two companies. But its success has not been limited to international business, since it does almost every kind of businesses that a domestic investment bank can do. The CICC is approved to engage in the following activities:

- agency trading of B shares, stocks issued overseas, government bonds and corporate bonds in both domestic and overseas markets;
- proprietary trading of B shares, stocks issued overseas, government bonds and corporate bonds issued in both domestic and overseas markets;
- underwriting A shares, B shares, stocks issued overseas, government bonds, corporate bonds issued in both domestic and overseas markets;
- sponsoring and managing funds;
- advising on various types of financing transactions, including project and structured financing;
- advising on corporate restructuring, mergers and acquisitions;
- providing investment and other advisory services;
- purchasing and selling foreign currencies;
- managing assets in foreign currencies for overseas enterprises and domestic foreign investment enterprises;

- Inter-bank lending.[233]

However, joint venture securities firms are far from being a common form of foreign participation and since there are no commonly applicable laws or regulations to guide the establishment and operation of such joint ventures. The CICC must be considered only as a particular and rare case.

ii) Legal Framework regarding Foreign involvement in Securities Sector

With more and more foreign securities firms setting up representative offices in China, the CSRC finally issued its *Provisional Measures on the Administration of the Representative Offices of Foreign Securities Firms*[234] in April 21, 1999. The *Securities Measures* defines foreign securities institutions as those investment banks, merchant banks, securities firms, and fund management companies which are incorporated outside China and engage in securities businesses. Representative offices established by these institutions within China are restricted to non-profit businesses such as consultancy, liaison, and market investigation.[235] To establish a representative office, an applicant must meet the following requirements:

- the state or region where the applicant is incorporated has complete financial laws and regulations;
- the applicant is approved by the authorities of the country or region where it has been incorporated to engage in securities business;

[233] See "About the CICC" online: <http://www.cicc.com.cn> (date accessed:12/04/2001).
[234] *Provisional Measures on the Administration of the Representative Offices of Foreign Securities Firms* (issued by the CSRC on 21/04/1999) online: <http://www.csrc.gov.cn/CSRCSite/bgsc> (date accessed: 12/04/2001)[hereinafter *Securities Measures*]
[235] *Ibid.* Art.2.

- good credit, no violation record, and making profits consecutively in the last 3 years before the submission of the application;[236]
- the general representatives[237] are required to have over ten years of financial business experience and two years of Chinese business experience over the last five years; the chief representative must have over five years financial or related working experience.[238]

The representative offices are required to submit working reports of the previous year to the branches of the CSRC by the end of February every year.[239]

Since the *Securities Law* of 1998 does not apply to B shares, and other overseas listed shares, the two regulations issued by the State Council and the CSRC in 1995 and 1996, respectively, namely *Regulations on the Listing of Foreign Investment Shares in China by Joint Stock companies* [240] and *Implementing Rules of the Regulations on the Listing of Foreign Investment Shares in China by Joint Stock Companies* [241], constitute the principal legal framework of B share markets.[242] *The Provisional Regulation for Administration of the Qualification of Domestic and*

[236] *Ibid.* Art 5.
[237] *Ibid.* Art. 9 For those securities institutions having set up more than 3 representative offices, they may apply to establish a general representative office within China and the person in charge of the general representative office is the general representative.
[238] *Ibid.* Art. 11.
[239] *Ibid.* Art. 16.
[240] *Regulations on the Listing of Foreign Investment Shares in China by Joint Stock Companies* (promulgated by Decree No. 189 of the State Council of PRC on 25/12/1995 and effective as of the same day) online: <http://www.csrc.gov.cn/CSRCSite/bgsc> (date accessed: 13/04/2001) [hereinafter *B Shares Regulations*]
[241] Implementing Rules of the Regulation on the Listing *of Foreign Investment Shares in China by Joint Stock Companies* (issued by the CSRC in 1996) online: <http://www.csrc.gov.cn/CSRCSite/bgsc> (date accessed: 13/04/2001).[hereinafter *B share Implementing Rules*]

Overseas Securities Institutions to Engage in B Share Business [243] issued by the CSRC on October 23, 1996, sets out the conditions for foreign securities institutions to participate in China's B share market.

Foreign Securities firms cannot participate in the business of A shares or broker foreign securities in China but they can broker B shares to their foreign clients. Investors in B shares must open B share accounts on the SHSE or SZSE, which are considered overseas accounts.[244] Dividends and capital gains from B shares can be sent abroad despite China's comparatively strict foreign exchange control.[245] To engage in B share business, domestic or overseas securities institutions must obtain a "B share business qualification certificate" from the CSRC.[246] To broker B shares through an agency agreement with Chinese domestic securities firms or other means specified by the stock exchanges, an overseas securities institution shall meet the following requirements:

- qualification to engage in securities brokerage in accordance with the law of the home state;
- under effective supervision of the regulator of the home state;
- net assets of RMB 50 million or equivalent or secured by overseas entity recognized by the CSRC;

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[242] Supra note 120 Art. 213 states that the State Council will prescribe specific measures separately for the purchase and trading of stocks of companies within China by people and organizations outside China with foreign currencies.

[243] *Provisional Regulation for Administration of the Qualification of Domestic and Overseas Securities Institutions to Engage in B shares Business* (issued by the CSRC on 23/10/1996) online at: <http://www.csrc.gov.cn/CSRCSite/bgsc/bflfg/f0436.htm> (date accessed: 1404/2001) [hereinafter *Qualifications Regulations*]

[244] *Supra* note 242 Art. 25.

[245] *Supra* note 241 Art. 26.

- at least two years international securities business experience;
- finance index of the last 2 years can meet risk control requirements of the home state;
- extensive business network;
- executive director and other advanced executives have at least 5 years securities business experience and good professional credit;
- not previously punished by overseas securities regulators for serious violations against relevant laws and regulations;
- observing laws and regulations of the PRC;
- at least two professionals with expertise in the Chinese securities market and its relevant policies, laws and regulations;
- other conditions the CSRC may require.[247]

To be a lead underwriter, joint lead underwriter or global coordinator of B shares, the overseas securities institution must meet the following conditions apart from the above:

- qualification to engage in the securities undertaking business according to the laws of the home state;
- net assets of RMB 120 million or equivalent or secured by an overseas entity recognized by the CSRC;
- continuous securities underwriting business in the two years prior to its application;

[246] *Supra* note 244 Art. 2.

- at least three professionals with expertise in China's securities market and its relevant policies and laws;
- other conditions the CSRC may require.[248]

The CSRC authorized the two stock exchanges to stipulate conditions through which foreign securities firms could enter into agency agreements with brokers in China or act as dealers in trading B shares.[249] The conditions specified by the SHSE basically duplicated the provisions of the *Qualification Regulations*[250]

The conditions of SZSE comprise:

- relatively strong in international securities business;
- good professional reputation;
- experience in developing international securities business.[251]

China's B share market has been feeble and sluggish since its establishment basically due to its small scale, lack of liquidity, the restriction on foreign securities firms, the uncertainty of shareholder's rights and other management problems. China's government has taken many measures to boost the market. On February 19, 2001 the CSRC announced that domestic residents were allowed to open B share accounts and engage in B share trading with legally held foreign currencies.[252] Although this may add to the liquidity of the market, it also reveals that the

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[247] *Ibid.* Art 6.
[248] *Ibid.* Art. 9
[249] See *supra* 242 Art. 33; Also see *supra* 120 Art. 133..
[250] See *Procedures for Securities Firms to Apply Trading Seats in SHSE* online: SHSE homepage <http://61.129.103.2/service/b/b3.htm or http://www.sse.com.cn> (date accessed: 15/04/2001).
[251] See *Provisional Rules on B Share Special Seats in SZSE* online: SZSE homepage <http://www.sse.org.cn/lawsystem/rule12.pdf> (date accessed: 15/04/2001).
[252] See, "China Open B shares to Demestic Residents" *Zhengquan Shibao [Securities Times, translated by the author]* (20/02/2001)1.

government's first effort to attract foreign investors to trade B shares was a failure and signals the possible eventual merger of A and B shares.[253]

III. LIBERALIZATION OF CHINA'S FINANCIAL MARKET AFTER CHINA'S ACCESSION TO WTO

A. China's accession to WTO – a "long march" yet finished

In late 1986 China formally notified the GATT that it would like to resume its contracting status in GATT.[254] In March 1987, as a response to China's application, a working party to examine China's status was set up by the GATT and met for the first time in October 1987.[255] Since then, both the Chinese government and the China Working Party of GATT (WTO after January 1995) have been working hard for China's accession. China once planned to be a founding member of the WTO, but it was bogged down in its accession to meet the 1994 deadline due to the problematic and protracted bilateral negotiation, especially with the US, and events such as the 1989 Tiananmen Tragedy.[256] After such setbacks in its campaign for

[253] Chinese officials have broached the merger of A and B Shares and then the merger of the SHSE and SZSE on many occasions. However, the definitive timetable has remained stubbornly hazy. See "The Prospects to Merger A and B Shares in China" *Guoji Jinrong Bao [International Finance News, translated by the author]* (15/03/2001)5.

[254] China was an original signatory to the GATT in 1947, but the Nationalist government that represented China that time withdrew China's membership in 1949 when it retreated to Taiwan.

[255] "China and the World Trading" *WTO Focus* (May 1997) at 5.

[256] The former WTO Director General of the WTO, MR Renato Ruggiero once explained China's difficult accession as follows: "It is because China's accession to the WTO will profoundly shape the future evolution and direction of global economic relations that we must get the process right. China is too large and important an economic player – and its entry into the WTO will have too great and impact on the system – to compromise these negotiations." "China and the World Trading System" *WTO Focus Newsletter* No. 19 (May 1997) at 5; US Trade Representative Barshefsky

WTO membership, the Chinese government seemed to be no longer enthusiastic about its WTO campaign and noticeably reluctant to make substantial improvements.[257] However, in April 1999, Premier Zhu Rongji of the PRC visited the US and offered a comprehensive settlement of trade matters between the PRC and the US intending to gain from the US the full support necessary for China's WTO accession. Objectively speaking, the Chinese government has made substantial concessions in services, agriculture and other matters such as government subsidies. However, the US President let the opportunity slip. Premier Zhu failed to get the warm response he expected, what he got was just a characteristic diplomatic understatement: "President Clinton and Premier Zhu recognize the complexity of WTO accession negotiations." When Premier Zhu Rongji returned to China, the US government released the content of the unaccepted offer. The logic of the US in releasing the terms was quite clear: to prevent possible backsliding by the Chinese government. But it was a political disaster for the Chinese Premier and his reform faction. Because the Premier gained nothing but a snub from the US, the conservatives began to accuse him of betraying the interests of the state and the interests of Chinese farmers.[258] The US's bombing of China's embassy in Belgrade was the last straw to the reform faction. After the incident, China canceled the bilateral trade talks with the US.

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attributed such a situation to China's reluctance to open its service sector, see *Washington Post*, (August 5, 1997).

[257] Willem Van Der Geest, "Bring China into the Concert of Nations – an Analysis of its accession to the WTO" (1998) Journal of World Trade 99 at 104.

[258] The Ministry of Agriculture fiercely opposes the entry of the WTO, because they think China is basically an agricultural country and farmers account for the majority population. The Premier's offer will consequently jeopardize the survival of Chinese farmers. Conservatives contend that entry into the WTO will lead to the collapse of state owned enterprises, unemployment, and bankruptcy in

Only after China's President Jiang Zeming and the US President Clinton met in Auckland during the Asia-Pacific Economic Cooperation Conference (APEC) held in September 1999, was the bilateral trade negotiation resumed.[259] Through some tough negotiations, China and the US finally signed a bilateral WTO accession agreement[260] in Beijing on November 15, 1999. On November 27, 1999, China and Canada signed the bilateral WTO accession agreement,[261] which signifies another step forward to WTO membership. After four rounds of talks, on May 19, 2000 China and the EC finally reached a bilateral agreement on China's WTO accession.[262] After so many years of effort, China finally seems about to put one foot in the door of the WTO.[263]

China actually performed quite well economically over these years without WTO membership. Through a careful perusal of China's WTO agreements with the US, one can see that China has made considerable concessions over its WTO accession. Contrariwise, most developed countries are only required to keep up the status quo. Below are a few examples:

China's financial sector as well as its infant telecommunication sector. Even the national security will be in danger givin the foreign participation in China's communication industry.

[259] "Key Events in China's WTO Bid," online: <http://www.chinadaily.com.cn/highlights/wto/data/keyevent.html> (date accessed: 17/04/2001).

[260] *China-US Bilateral WTO Accession Agreement* (15/11/1999), online: <http://www.uschina.org/public/wto/market> (date accessed:20/04/2001)

[261] *China-Canada Bilateral WTO Accession Agreement Summary* (27/11/1999) online: <http://www.dfait-maeci.gc.ca/tna-nac/China-Summary2000-e.asp> (date accessed: 20/04/2001)

[262] *China-EU Bilateral WTO Accession Agreement Summary* (19/05/2000) online: <http://wwweuropa.eu.int/comm/trade/bilateral/China/res.pdf>. (date accessed:20/04/2001)

[263] On January, 2001, when the working party on China's accession, made up of dozens of countries that have outstanding trade issues with China, broke up in Geneva last month without an agreement, some of (continued...) the US Congressmen threatened to reconsider China's PNTR if China

- China's most competitive products are apparels, but the WTO members may impose quotas on textiles and apparel products originating in China when imports of such products are considered to be "disruptive" to domestic markets and these quotas could remain in force until the end of 2008.[264] However, according to WTO rules, textile quotas would normally expire in 2005.
- the US will be able to maintain its "special anti-dumping" methodology for 15 years after the date of entry into force of the protocol.[265] This means China will be treated as a non-market economy despite the fact that in 1999 the share of foreign investment enterprises has accounted for 49% of China's total trade.[266]
- the US can keep the "special safeguard rule" for 12 years after China's accession. In other words, whenever the US considers the unexpected import surges disruptive to the domestic market.[267] The standards for these safeguards are much lower than those for the normal safeguards specified in the WTO Safeguards Agreement.

These provisions are against the spirit of the WTO, but the US and other countries will be able to apply unilaterally while China has no recourse under WTO rules. This being the case, what is the incentive for China to accept such harsh provisions, to incur the considerable cost of domestic adjustments according to the

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remains outside the WTO by the end of 2001. It is therefore likely that China will try to enter the WTO by the end of 2001.

[264] See supra note 260 *Draft Language on Textiles*; also see "the USTR Barshefsky's Press Remarks Following Negotiations with China on the WTO," online: <http://www.ustr.gov/releases/1999/11/cbchina.html> (date accessed: 20/04/2001).

[265] *Ibid.*

[266] Country Statistics from US-China Business Council, online: <http://www.chinabusinessreview.com/foreigninvestment.html> (date accessed: 23/04/2001).

[267] *Supra* note 260.

commitments specified just in order to get a membership when the principal benefits of membership are already in hand? To answer this intriguing question we must first ask two questions: whether China will join the WTO at all, and whether China can further implement its economic reforms and join the WTO when its service sector and other sectors are competitive enough. In addition one needs to understand the special importance of politics in China.

In the words of Mike Moore, the new Director-General of the WTO, "The WTO is not a world organization until China sits at the table as a partner, as a super-power, as an important player. So the question is not if (China enters), but when and how."[268] China will not be a real player in international society without membership of the WTO. So it is clear that China will be a member of the WTO sooner or later. But the bidding for entry will be played at a higher premium with elapse of time. Premier Zhu's offer would have secured China's membership, had China offered this in 1994. Albeit China made no progress in its under- developed sectors such as agriculture and services during this period, it consequently had to substantially improve its new offer for WTO membership. Now that China is determined to be a WTO member, the sooner the better.

Over the past two decades, foreign investment has become more and more vital to the growth of China's economy. The 1997 Asia Crisis began to tell on China's economic development in 1998. Endemic deflation posed a serious challenge to any

[268]See Mike Moore's speech , online: <http://www.wto.org/english/news_e/news99_e/news99_e.htm> (date accessed: 25/04/2001).

attempt to stimulate China's economy.[269] The government tried to stimulate the economy through infrastructure programs, but the government cannot continue to drive the economy indefinitely without an increase in private sector spending.[270] The State owned enterprises (SOE) – products of command economy - are destined to perform poorly in a market-based economy. Therefore, the performance of foreign investment enterprises became critical for China's economic growth.[271] Unfortunately, foreign investment began to show a downturn in 1998 for the first time ever.[272] WTO membership then became a promising choice that would boost the confidence of foreign investors and attract a wealth of new money to stimulate the slowing economy. In addition, overhaul of the SOE has been a prerequisite for the reform of China' s state banks, which are virtually insolvent by international standards.[273] The overhaul of SOEs will present a daunting unemployment problem. To solve this problem China needs to maintain an adequate economic growth rate.[274]

Without the support of China's President Jiang Zeming, it would have been impossible for China to reach the WTO accession agreement with the US. President Jiang is not an expert in economics, but as a politician, he believes in

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[269] Mark. A Groombridge, "China's Accession to the WTO" (2000) online: <http://www.fas.harvard.edu/~asiactr/haq/200002/0002a001.htm> (date accessed: 25/04/2001).
[270] *Ibid.*
[271] Ibid.
[272] The FDI in China's Equity Joint Venture in 1997 was US$ 19.50 billion and reduced to UD$ 18.35 billion in 1998 and further reduced to US$ 15.83 in 1999. The FDI in Wholly Foreign-owned Enterprises was also reduced from US$16.74 billion in 1998 to US$ 15.55 billion in 1999, see FDI Statistics concerning Chins, online: <http://www.chinabusinessreview.com/foreigninvestment.html> (date accessed: 26/04/2001)
[273] See "Bank Industry Risk Analysis: China" (2000), online: Standard & Poors homepage <http://www.standardpoors.com/ratings/financialinstitutions/165515f.htm> (date accessed: 26/04/2001).

multilateralism and wants to participate in making rules with other members within the WTO. Furthermore, as the third generation leader of the CCP, President Jiang needs to accomplish "feats" capable of eclipsing the record set by Mr. Deng Xiaoping during his tenure. Entering the WTO as a means of capping of China's economic reform initiated by Mr. Deng Xiaoping, became a natural choice.[275] For Premier Zhu Rongji, entry into WTO would help him to deepen economic reforms in banking and telecommunications sector where he had initially encountered great resistance and it would ensure the continuity of reforms after his retirement in 2002.[276]

B. China's Commitments in Financial Sector and Foreign Participation after China's Accession to the WTO

On November 15, 1999, the headquarters of China's "big four" state banks were suddenly in a state of panic: the leaders were busy discussing how to tell the same story to the media and their employees were all staring at their computer screens. The "big four's" most apprehensive moment finally came: China and the US signed the WTO accession agreement. Two months earlier the leaders of the "big four" together wrote to the central government to advise it not to open the financial sector in hasty manner. This was because, for the first time, they acutely felt their very

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[274] *Ibid.*

[275] Reunification with Taiwan is his primary aim. WTO membership will help China to set up an economic connection directly and it will consequently be conducive for talks between the two sides of the Taiwan Strait.

[276] Actually, after China and the US signed the WTO Agreement, the banking, insurance, and telecommunication sectors immediately began to make adjustments to meet the incoming competition. For many years, transformation of the ownership structures of the state banks had been taboos. But now, given acute imminent international competition, plans for going public and similar issues were discussed.

survival was in question. However, the fact that China and the US signed the WTO accession agreement revealed that their opinion was not accepted. The following is a specific analysis of China's commitments in the financial sector, which caused considerable anxiety among the leaders of China's state financial institutions.[277]

i) Commitments in Banking Sector

China's Sector or sub-sector commitments in banking services basically comprise those defined under the GATS:

- acceptance of deposits and other repayable funds from the public;
- lending of all types including consumer credit, mortgage credit, factoring and financing of commercial transaction;
- financial leasing;
- all payment and money transmission services, including credit, charge and debit cards, travelers' checks and bankers drafts;
- guarantees and commitments.[278]

With regard to market access, China has committed to the following:[279]

- foreign banks will be able to conduct local currency business with Chinese enterprises 2 years after accession;
- foreign banks will be able to conduct local currency business with Chinese individuals five years after accession;

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[277] The analysis of China's commitments is based on the WTO accession agreement between China and the US, China and the EU. The two super powers have the most bargaining power and according to the
MFN principle, and consequently any concessions obtained by one member would benefit all the other WTO members to the same extent.
[278] *Supra* note 260.
[279] *Supra* note 260.

- both geographic and customer restrictions will be removed in five years;
- foreign banks will enjoy national treatment within designated geographic areas;
- issuance of licenses to deal in China's financial sector are solely prudential;
- financial institutions that meet certain conditions are permitted to set up subsidiaries, branches and joint ventures;[280]
- Full market access for US banks within 5 years.

The fresh concessions obtained by the EC beyond those negotiated by the US in the banking sector are as follows:

- Distributors and other non-financial institutions will be able to provide credit facilities for the purchase of trucks, buses, tractors, motorcycles and other motor vehicles;
- Banks in Zhuhai, a city just off Macao and where several EC banks operate, will be permitted accelerated access to the local currency business.[281]

ii) Commitments in Insurance Sector

The sub-sectors that China has committed to in the insurance sector include:

- life, health and pension/annuities insurance;
- non-life insurance;
- reinsurance;
- services auxiliary to insurance, excluding brokerage services.

With respect to market access in the insurance sector, China has committed itself as

[280] Specifically, the conditions for subsidiaries necessitate total assets of more than US$ 10 billion at the end of the year prior to filling the application; the branches, US$ 20 billion; the joint ventures, US$ 10 billion.

[281] See, *supra* note 262.

follows:

- progressive elimination of all geographic limitations within 3 years and permission for internal branches with the elimination of these restrictions;
- expanding of the scope of activities for foreign insurers to include group, health and pension lines of insurance, representing 85% of the premiums, phased in over 5 years;
- allowing 50% foreign ownership of life insurance, and foreign life insurers to choose their own joint venture partners; allowing non-life insurance branching or 51% ownership on accession and wholly owned subsidiaries in 2 years; complete opening of reinsurance upon accession;
- awarding licenses solely on the basis of prudential criteria, with no economic tests or quantitative limits on the number of licenses issued.[282]

The EC even increased China's commitments in the insurance sector above what the US has already obtained.

- The EC obtains 7 new licenses, 5 for life and 2 for non-life business, which will be provided to EC companies upon China's WTO accession;
- scope of business is advanced by two years in life and non-life activities, including the sale of health, pension and group insurance in life, and all non-life products except for statutory insurance;
- opening of Shenzhen and Foshan accelerated;
- Brokers will have access to the Chinese market for the first time through cross border and commercial presence. They will be able to undertake large-scale commercial risk and reinsurance business. 50% foreign ownership is allowed

upon China's accession and the majority allowed within 3 years and no equity restriction within five years.[283]

iii) Commitments in Securities Sector

China's Securities sector is really in its infancy, and so the commitments in this sector are not as substantial as in other financial sectors.

- upon accession joint ventures with up to 33% equity foreign ownership may conduct fund management on the same terms as Chinese firms. Three years after accession, foreign ownership of these joint ventures will be permitted to rise to 49%. Since the Chinese firms are allowed to expand the scope of business, the foreign securities firms can follow suit.
- Those joint ventures with up to 33% foreign equity will be allowed to engage in underwriting A shares and underwriting and trading international equity and all corporate and government debt issues (without a Chinese intermediary).[284]

C. A Brief Assessment of China's Commitments from a Comparative Perspective

A comprehensive analysis of the commitments of WTO members in the financial sector will constitute too large a project. Thus, if we select India, which has a comparable economic scale and development level to China, and South Korea, a more developed Eastern Asia state, we can adequately determine whether China's commitments in financial sector is favorable to foreign businesses.

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[282] *Supra* note 260.
[283] *Supra* note 262.

In the banking services sector, foreign investors are allowed to establish subsidiaries of foreign banks or finance companies, branches, and joint ventures to deal in committed sectors. The only form permitted in India is branch operations of a foreign bank licensed and supervised as a bank in its home country. Licenses for new entrants and existing banks are limited to 12. Installation of ATM at a place other than in licensed branches is treated as a new license. Licenses for new foreign banks may be denied when the maximum share of assets in India, both on and off balance sheet of foreign banks, to total assets, both on and off balance sheet of the India banking system, exceeds 15%.[285] In the case of South Korea's commitments, foreign commercial presence respecting deposits and related services are limited to branches of foreign banks that rank among the world's top 500 banks. Mandatory lending to small and medium-sized companies is required.[286]

Due to the crucial importance of life insurance to the national economy, most countries impose limitations on foreign involvement. China allows 50% foreign equity in joint ventures and grandfathers those with equity exceeding 50% that has already been obtained. In South Korea, the establishment of joint ventures with Korea life insurance are not allowed.[287]

Many developing countries impose certain personnel recruitment limitations. India requires foreign banks to constitute Local Advisory Boards, where the Chairman

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[284] *Supra* note 260.

[285] *India Schedule of Specific Commitments Supplement 4* WTO Doc. GATS/SC/42/SuppL4, online: <http://www.wto.org> (date accessed: 26/04/2001).

and members must be resident Indian nationals.[288] In Korea, the recruitment and employment of local insurance professionals, including sales personnel, by foreign insurance companies are restricted.[289] Taking into consideration the salary disparities between foreign and domestic financial institutions and its lack of restriction in this connection, one can readily predict a talent drain for China upon its accession to the WTO.

In sum, China's commitments are more general and generous, with fewer specific limitations. This may in fact be just a reflection the lack formal regulation and the under-development in this sector in China.

PART III. PROBLEMS AND PROSPECTS: OBSERVATIONS AND RECOMMENDATIONS CONCERNING THE LIBERALIZATION OF CHINA'S FINANCIAL MARKET

"There is nothing more difficult to plan, more doubtful of success, nor more dangerous to manage than the creation of a new system. For the initiators have the enmity of all who would profit by the preservation of the old system and merely lukewarm defenders in those who would gain from the new one." _____Machiavelli, Nicolo, from *The Prince.*

After 15 years of effort, China finally put one foot in the door of the WTO after signing the WTO accession agreement with the EC. However, China is far from

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286 *Republic of Korea Schedule of Specific Commitments Supplement 13*, WTO Doc. GATS/SC/48/SuppL13, online: <http://www.wto.org> (date accessed: 26/04/2001).
287 *Ibid.*
288 *Supra* note 286.

ready for foreign competition in its services sector, especially, the financial service sector. China has accelerated its reforms in the financial sector. However, for a project that involves a restructuring cost of RMB 2.5 trillion, accounting for 31 percent of the gross domestic product,[290] and in a sector that has a legacy of substantial non-performing loans as a result of policy lending, the future of the reform may prove to be anything but certain. In this section, the problems and prospects of China's financial service sector will be discussed.

I. PROBLEMS IN CHINA'S FINANCIAL SERVICE SECTOR

On the one hand, China has actively sought foreign direct investment (FDI) to promote its modernization in all sectors since its opening up in 1978. The total amount of incoming FDI reached $ 320 billion in 1999 and it has thus become the world's third largest (second until 1998) recipient of FDI, and the largest recipient among developing countries.[291] The economic reform has greatly changed the capital allocation framework in China and the service industry has begun to assume an important role in China's economic development. On the other hand, the Chinese service industry is still at a nascent stage in its development with its percentage in GDP merely higher than the average run of developing countries.[292] China's financial industry is not yet able to vie with its counterparts in the West not only because of its assets quality and the short period of service innovation but also

[289] *Supra* note 287.

[290] The Standard & Poors estimated that the cost of recapitlizing the banking sector could exceed 40% of 1999 GDP or RMB 3.3 trillion, online at: <http://www.standardandpoors.com/ratings/financialinstitutions/165515f.htm> (date accessed: 27/04/2001).

[291] "Foreign Direct Investment in China" (2000), online: <http://www.oecd.org/daf/conference/china/> (date accessed: 28/04/2001).

because of inadequate risk control and outdated supervisory structure. For quite a long time, Chinese banks, insurance companies and securities firms have been insulated from competition. Such excessive protection has resulted in low efficiency and out-of-date techniques.

A. Lack of Competition

Competition within China's banking sector is weak and has a limited role in promoting banking efficiency. From the mid-1980s to the mid-1990s, although the four state banks expanded their scope of business and gained some limited autonomy, their role as policy lending conduits for the government remained basically unchanged. Therefore, there was virtually no competition between them.[293] With the establishment of state policy banks to take over the policy lending of the state banks, the four state banks were expected to operate on market principles. However, the policy banks were not able to maintain the level of policy lending previously provided by the four state banks due to their lack of capital and their insufficient number of branches. Therefore, the four state banks were pressed to continue their policy lending in one form or another by local or central government.[294] Consequently, there is still not much competition between the "big four."

By the end of 1999, there were a total of 12 joint-stock commercial banks with total

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[292] Dai Chaoping, *Gouji FuwumaoyiGailun* (Beijing: China Financial Press, 1997) at 88.
[293] Richard Wong, *Competition in China's Domestic Banking Industry* (Hong Kong: Hong Kong Center for Economic Research, 2000) at 1-2.

assets of RMB 1147.7 billion and 90 city cooperative banks with total assets of RMB 554.7 billion (US$ 67 billion). However, compared with the "big four" in term of assets, deposits, and loans, they were dwarfed by the dominant percentage of the "big four" which reached respectively 84.93%, 84.26%, and 88.51% in 1998.[295] Furthermore, restriction on interest rates for different deposits by the PBOC has ruled out price competition in the deposits market. Therefore, in spite of the better performance of the joint stock commercial banks in capital adequacy ratio and profit making, they still can not challenge the dominant position of the "big four" in that the deposits in the "big four" are guaranteed by the Central government and the 145,000 branches of the "big four" are now to be found in all the areas above county level.[296]

Since there are geographic and customer restrictions on the handful of foreign banks permitted to engage in RMB business, the competition pressure on the "big four" is negligible at present.[297]

Monopolies in the insurance sector are even more apparent. Although 13 domestic insurance companies and 16 wholly foreign owned branches and joint ventures have be established since 1988, the PICC (the property sector of the former PICC) alone has over 70% of the market share and together with the Ping An Insurance and the

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[294] Even the *Commercial Bank Law*, which supported the autonomy of the state banks, stated that a commercial banks shall issue loans in accordance with the needs of the national economy and social development, and under the guidance of state industrial policies.
[295] *Supra* note 293 at 4.
[296] A telling slogan used by the state banks is "state banks, state credit." China's financial market is still in its nascent stage, there are not many banking products. For ordinary people, safety and convenience are the two major elements which determine where they will deposit.

China Pacific Insurance, they have taken over 98% of the market share for insurance services in China.[298] Foreign insurers are restricted to Shanghai and Shenzhen and their competitiveness is still relatively limited.

B. Non-performing loans

Non-performing loans, in international practice, refer to those loans on which either an interest or principal payment is 90 or 180 days past its due date, and those are important indicators of the health of a banking system.[299] Failure to return any single loan of the loans lent to a single borrower will entail classification of all the loans. The loan classification system in China is more lenient.[300] Banks in China are required to classify their loans either as normal, past due, doubtful, or bad. Since 1998, "past due" has been used to refer to loans of which repayment of the principal is in arrears, while doubtful has been referred to loans that have been in arrears for more than one year.[301] China's "non-performing loans", as a share of their total loans, increased from 20% at the end of 1994 to 22% at the end of 1995. On January 17, 2001, China's central bank governor Dai Xianglong claimed that by the end of 2000, 25% of the due loans of the "big four" had not been recovered. Taking into account that this figure was obtained by stripping off non-performing loans of 1.3 trillion to state-owned asset management companies, the equity ratio of China's state-owned banks would have been in negative had more conservative international

[297] *Unfinished Revolution, supra* note 96, at 166.

[298] "Zhongguo Baoxianye Congzu Miandui Waiguo Jingzhe" *Zhonggou Jingji Shibao* (31/03/1999).

[299] Nicholas R. Lardy, "China and the Asian Financial Contagion", in Baizhu Chen et al., eds., *supra* note 57 at 31.

[300] In 1998, the government requested the state-owned banks to implement the five-category, risk-based rating system, namely, normal, special-mention, substandard, doubtful and loss in the branches in Guangdong and Zhejiang province.

accounting standards been applied.[302] Although the state banks transferred part of their non-performing loans to the AMCs for the time being, however, if Chinese government does not soon overhaul its banking sector and follow international banking practices, these state banks will inevitably accumulate non-performing loans as before.

C. Underdeveloped Financial Services and Limited Investment Vehicles

The financial services provided by Chinese Banks are mainly limited to basics in fund intermediary and payment services. Unlike the profit structure of the banks in Western countries where intermediary business income comprises over 50% of their total profit, 80% of the income of Chinese banks is derived from interest.[303] Only in April 1999 did the PBOC issue rules that forbid people to open personal savings accounts under false names. Accordingly, virtually no personal credit system has been established till now and credit cards are not commonly used. Financial services respecting risk transfer and financial engineering are underdeveloped.

China's banks play a dominant role in China's financial markets. They control 90% of the intermediary business between savers and the investors in China.[304] The total

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[301] *Unfinished Revolution*, *supra* note 98 at 116.

[302] Since 1998 the government has established the China Great Wall Asset Management Company, China Huarong AMC, Cinda AMC and Orient AMC, respectively, to deal with the non-performing loan problems of the ABC, ICBC, CCB and BOC through debt-for-equity swaps, debt collection, debt exchange, debt transfer and sale, debt restructuring, stock listing and the underwriting of bonds, direct investment and the issue of bonds. Given the poor performance of SOEs and the lack of experts and experience in disposing of non-performing assets, it is estimated that the recovery rate will be under 20%.

[303] Yi Xiaozhun and Tangxiao Bin, *Maoyi Ziyouhua De Tiaozhan –Fangzhi Qiche Jingrong Nongye and Fengxian yu Duice* (Beijing: Zhongyang Bianyi Chubanshe, 1998) at 169.

[304] Nicholas R. Lardy, "China and the Asian Financial Cantagion" in Baizhu Chen et al., eds., at 28.

bank loans in 1998 were RMB 8.6 trillion, representing 109 percent of China's GDP. The total market capitalization in China's two stock exchanges reached 4.6 trillion by the end of 2000, but the liquid market capitalization stands at about one third of this capitalization, since two thirds of the capitalization consists of state shares and state-owned legal person shares that may not be traded at present.[305] The market capitalization of the stock markets in most developed countries exceed 100% of their GDP. Although 56 million investors have opened accounts in the two stock exchanges, the majority of them are individual investors and there is a lack of institutional investors. Due to the quota system which determines access to the capital markets, the stock markets are actually a place for the SOEs to suck capital; they are not a conduit for the transfer of capital to non-state owned companies. Because of problems such as rampant over-speculation, manipulation, insider trading and the non-transparent accounting system, the Chinese stock markets are so volatile that the majority of Chinese people prefer to deposit their money in banks. Household deposits, which have been growing at an average rate of 36.7, account for 80% of total bank assets. By the end of 1999 household deposits reached a level of RMB 4.6 trillion.[306]

D. Insufficient Development in International Businesses

According to the definition given by the UN Transnational Center, transnational banks refer to the commercial banks that engage in international banking with overseas turnovers accounting for no less than 25% of their total business, and

[305] Zhou Xiaochuan, Supra note 141.

which have established branches or subsidiaries in at least five countries. At present, only the BOC can meet these standards with its 47% turnovers from overseas business in over 19 countries.[307] Other Chinese banks only started their international banking in recent years and the format is basically restricted to representative offices. China's transnational banking is in its fledgling stage and lacks the required expertise to launch a comprehensive program of international business. To reap the full benefits of liberalization under GATS with China's upcoming WTO accession, Chinese banks must hone their ability to compete in the international arena, not just stand by and watch their market share being grabbed by foreign banks.

II. THE ASIA FINANCIAL CRISIS – IMPLICATIONS FOR CHINA'S FINANCIAL REFORMS

The 1997 Asia financial crisis caused considerable turmoil in Indonesia, Korea, Malaysia, Thailand, and the Philippines. China was largely unscathed by this financial contagion because of the absence of capital account convertibility, the majority of foreign investment in the form of the FDI and a sufficient foreign exchange reserve.[308] Although the comparatively closed financial market helped China to remain insulated from the Asia financial contagion, China must nonetheless liberalize its financial markets since a closed market will only result in

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306 Zhang Jun, "Jingrong Zhidu Xiaolu Yu Woguo Jingrong Gaige de Wenti" (2000) 2 Shijie Jingji Yanjiu 23 at 25-27.

307 "Bank of China Launches Full-fledged Investment Bank in Overseas Business Regrouping"(2000), online: <http://www.bocgroup.com/content/eng/whatsnew/news6.html> (date accessed: 29/04/2001)

308 Nicholas R. Lardy, "China and the Aian Financial Contagion" in Baizhu Chen et al., eds., at 35.

international backwardness and isolation. China shares many characteristics such as the misallocation of resources associated with policy lending, non-performing loans, inadequate prudential supervision, moral hazard problems, which led to the financial crisis in Asia. The Asia financial crisis had profound implications for China, especially at a time when China's economic reform has reached a critical stage, since the reforms of the financial sector and the state-owned enterprises have just begun. In this respect, this financial crisis could provide valuable lessons for China, and help it to avoid similar policy mistakes during its process of economic liberalization and integration within the global economy.

A. Financial Structure Fragility

There is a growing consensus that the Asia Financial Crisis is a financial structural crisis and the only way out of this crisis is to overhaul the oligopolistic and fragile financial structures prevalent in Asian Countries. A complete financial system comprises three sub-systems: the financial institutional system, the financial instrument system and the financial market system. A balanced and coordinated development of these sub-systems is the prerequisite for a stable and resilient financial system capable of further integration with international financial markets.[309] Without prudent and transparent financial institutions, without allowance for market entry and exit, and without diversified financial vehicles, such a mature financial system can never fully come into being. In addition, the fact that Hong Kong's financial market – a totally liberalized and mature financial market

[309] Lou Xing, Shen Tianying, "Lun Fazhanzhong Guojia Jingrong Ziyouhua Gaige" (1997) 10 Shijie Jingji 9 at 17- 19.

survived better than those in the emerging markets proves that it is not liberalization per se in financial markets but the absence of a healthy, mature and disciplined financial market that led to financial turmoil.[310] China basically suffers from all those symptoms that the other countries manifested in the Asian Financial Crisis. A more opened financial market is not necessarily the government's choice, but the market's choice. Risks associated with foreign capital can be significantly reduced but never eradicated. What the Chinese government can certainly do is to strengthen its financial system, and improve its legality.[311]

B. "Big Bang" or Gradual Approach

The goal of financial liberalization is to strengthen competitiveness in the financial sector and hence realize the allocation of resources according to market forces. The Asia financial crisis revealed that it is crucially important to sequence financial liberalization in a proper manner. Without the existence of a sound financial system, such liberalization may subject the economy to massive international capital volatility.[312] Generally, two approaches have been adopted to the question of financial liberalization – the "big bang" approach and the gradual approach. The former approach is principally characterized by broader and more rapid measures and it advocates the replacement of government regulations with market discipline at the earliest date; by contrast, the latter approach emphasizes the strengthening of institutional capacities in terms of financial regulations and risk management before

[310] Alec Tsui, "Lessons from Hong Kong's Experience of the Crisis" in Douglas H. Brooks et al., ed., *Financial Liberalization in Asia – Analysis and Prospects*, (Paris: OECD 1999) at 43-47.
[311] Lou Xing, Shen Tianying, *supra* note 315.

undertaking the liberalization of the financial sector, and it focuses on market failures and the role of government to correct failures before proceeding with further liberalization. In the transition of Eastern Europe's economy, the "big bang" approach was commonly adopted. The advantage of the "big bang" approach is that it can reduce government interference in the shortest possible time. The downside of this approach inheres in the possible social commotion and the huge economic costs.[313] The gradual approach has been more commonly used to usher in financial reforms of market economies due to its resilience in adjusting to the changing environment with minimum social and economic costs. Most Asian countries have implemented financial reforms using the gradual approach, albeit not in the recommend sequences i.e. domestic market liberalization before capital account liberalization, loan interest rates before deposit rates, long-term interests liberalization before short–term interest rates liberalization.[314]

China has been carrying out its economic reforms slowly yet unrelentingly. Pilot projects were first established in a small region and then expanded to a larger area only when they proved to be successful. This is because, on the one hand, China is such a vast country, with over 1.2 billion people and uneven regional development, that the failure of a "big bang" approach would be disastrous to China as well as the world; on the other hand, the reformist must overcome resistance from conservatives through the proven success of carefully chosen pilot projects. In the

[312] Douglas H. and Soo-Nam Oh, "Asia's Financial Crisis: Is Financial Liberalization the Villain?", in Douglas H. Brooks et al., eds., *supra* note 310 at 91.
[313] *Ibid.*
[314] *Ibid.* at 94-96.

reform of its financial sector, China has also taken a gradual approach. Currently, loan interests rates must be within a government-set range while deposit interest rates are still under government control. In late 1999, following the liberalization of inter-bank market rates, the PBOC announced that more discretion would be given to commercial banks to set interest rates.[315] With its upcoming accession to the WTO, China should accelerate its liberalization of the domestic financial market so as to strengthen its institutional capacity and regulatory framework.

C. Capital Account liberalization

Capital account liberalization involves removing capital controls and restrictions on the convertibility of a currency.[316] With complete capital convertibility, companies and individuals become free to move their financial resources from country to country in response to their views on changing market conditions, and to invest them in the assets of their choice. Capital account liberalization can have a mixed impact on economic development. On the one hand it may enhance the allocation of investment capital; on the other hand, it may attract speculative capital into the economy, causing financial instability and catastrophe. The Asia financial crisis has clearly given capital account liberalization a bad name. Many observers contributed the Asia financial turmoil to the huge surge of international capitals, particularly the short-term inflows.[317] Large short-term inflows led to easy funding for projects and asset prices were bid up. The common practice of local banks of relying on the

[315] Richard Wong, *supra* 293 at 14.
[316] Pierre Sauve, "The Benefits and Investment Liberalization: Financial Services" in Douglas H. Brooks et al., eds., *supra* note 316 at 182.[hereinafter "Benefits for Liberalization"]

availability of collateral rather than on the rigorous analysis of profitability encouraged huge credit expansion hand-in-hand with the rise in asset prices and the value of collateral. Such practices also skewed bank lending towards real estate and construction. Given the unfavorable external developments, coupled with a weakening of the domestic economies in these Asian countries, these countries all suffered a sudden reversal of capital flows.[318] Then the crisis exploded.

China was largely unscathed during the Asia financial turmoil partially due to its absence of capital convertibility. However, this by no means demonstrated that sustainable development could be achieved without capital account liberalization or that liberalization per se resulted in the financial turmoil. Actually, had liberalization efforts been accompanied and bolstered by greater transparency, predictability and competitiveness, the crisis might well have been less likely or, at least, have been considerably less serious.[319] Therefore, Asia financial crisis should not become an excuse for the postponement of capital account liberalization as a means to shield China from a future regional financial crisis. Nevertheless, certain prerequisites and steps must be met and followed in respect of the capital account liberalization. Prerequisites for capital account liberalization include:

- rational exchange rate mechanism and sound macroeconomic policies: China established a single managed floating exchange rate based on the market and supply in 1994 through merging the two-tier state-regulated exchange rates and

[317] Jianping Zhou, "Roots of the Financial Crisis in Asia and Implications for China", in Baizhu Chen et al., ed., *supra* note 57 at 42-44.
[318] *Ibid.* at 46.
[319] "Benefits for Liberalization" in Douglas H. Brooks et al., eds., supra 310 at 182.

market exchange rates. However, the new system was flawed because of the PBOC interference in exchange rate fluctuations. In addition, the central bank should have had more independence in making and implementing monetary policies. These policies should be coordinated with fiscal policies to maintain the stability of the macro-economy.[320]

- improved pricing structure: marketization of interest rates means the complete freeing up of the capital price. It will require Chinese enterprise to respond rapidly to domestic and international price fluctuations by adjusting production so as to maximize economic returns and profits. Only in so doing can pricing signals and competition mechanisms play their appropriate role.[321]
- A sound financial system: reform of the domestic financial market must proceed or at least go simultaneously with the liberalization of capital account. The liberalization of the capital account depends on a mature financial system and a well-developed financial market. Specifically, the following aspects must be strengthened:

    a) The central bank's regulatory and supervisory framework concerning monetary policy must be perfected. The PBOC should practice risk control management and fully implement the recently introduced five-tier classification of loans.[322] Before the PBOC can carry out effective supervision, the state commercial banks must be recapitalized to raise their capital adequacy close to the standard set out in Basle Core Principles.

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[320] Yi Feng, "Capital Account Liberalization: Sequencing and Implications" in Baizhu Chen et al., eds., *supra* 57 at 97-98.
[321] Wu Nianlu, "Zhongguo Yinggai Kaifang Ziben Zhanghu" *Zhongguo Gaige Bao* (31/03/2000).
[322] *Unfinished Revolution*, *supra* note 96 at 117.

b) The capital market should be further developed to foster investment diversification, increase the proportion of direct financing, promote the transformation of the SOE into modern joint-stock companies and develop the T-bond market. The money market should be expanded and standardized, particularly, the development of the inter-bank loan market, the repurchase agreement market and the commercial paper market should be accelerated.

c) State owned commercial banks should speed up their transition to market oriented commercial banks. Internal risk control mechanisms and corporate governance should be strictly implemented.

d) Geographic and business restrictions on foreign banks should be gradually removed so as to allow foreign banks to integrate within China's financial system and create an even competition ground for all participants in this sector.[323]

With regard to capital account liberalization, a gradual approach should be adopted. Firstly, the liberalization of long-term capital flows should proceed short capital flows; secondly, restrictions that do not affect the current account balance can be relaxed first, those that affect the current account should be relaxed on limited parameters at first; thirdly, restrictions on capital out-flows on resident institutions should be relaxed before restrictions on residents within Chinese territory.

III. RECOMMENDATIONS FOR FINANCIAL REFORM IN CHINA

A. Development of National Financial Services

Globalization of financial services does not mean that the economy of each individual state has lost its ground for independent existence. For each sovereign state, national interest still represents the fundamental interest of the nation. In the world today, national interest can not be realized by closing the market, but liberalization of the market will put the national industries and markets into direct competition with foreign enterprises.[324] The World Bank's chief economist and senior Vice President, Joseph Stiglitz, once said that only when the Asian countries have strengthened their own development in the financial sector, can they rehabilitate their economic growth rate to what it was before the Asia Financial Crisis. The report released by the International Financial Corporation under the World Bank in 1998 emphasized that the Asian economic miracle had never really expanded to the financial sector. Although foreign capital plays a very important role in the economic development of Southeast Asian countries, true economic growth must still primarily rely on the production power created by investments from national deposits.[325] No exception, all those countries that have successfully completed their industrialization have firmly established their financial service industries and trade in financial services.[326] The essence of financial competition in the international arena is competition between enterprises, not between the states participating in the negotiation of international financial agreements. Only through fostering competitiveness of the national financial industry, can a country integrate

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[323] *Ibid.* 96 at 165-168.
[324] He Xiaoqin, "Kuangguo Gongsi yu Jingji Quanqiuhua" (1998) 13 Shijie Jingji Yanjiu 20 at 23.
[325] "Guoji Jingrong Gongsi Cheng Jingji Fushu Kao Benguo Jingrong Tizhi" *Guoji Shangbao* 910/10/1998).

itself into the international financial market and reap the benefits brought about by financial globalization. Therefore, without a strong national financial system, there will be no stable and sustained economic development.

GATS and the Understanding on Trade in Financial Services provide certain preferential treatments for developing countries. However, the commitments by developed countries on market access and national treatment do not necessarily bring any real opportunities for the developing countries to develop their own financial industry. While the financial market of the US is open to many developing countries, few financial institutions from these countries have the potential to compete with US financial institutions and the financial institutions of other developed countries. Even the clauses to provide techniques to developing countries on a commercial basis do not bear much practical fruit. Those techniques are not possessed by the government, but by transnational financial institutions. While the relationship between states are political competition, cooperation and compromise, as well as well as the relationship between enterprises follows market principles. Therefore, the commitments of a state to transfer techniques do not necessarily mean that the enterprises of the developing countries can develop the technique easily. Thus, a commitment to market access and national treatment is just one kind of potential benefit for developing countries. If the financial institutions in the developing countries lack the ability to make use of these conditions, then these institutions will hardly be able to get any real benefit from the application of the NT

[326] Zhang Hanlin, *Jingmao Jinzheng Xin Lingyu – Fuwu Maoyi Zong Xieding Yu Gouji Fuwu Maoyi* (Beijing: Zhongguo Jingji Chubanshe, 1997) at 384.

and the MFN in financial sectors.[327]

The Chinese government is in a dilemma about whether to liberalize its financial sector: on the one hand, it is committed to phase out most of the restrictions concerning foreign participation in China's financial sector within five years of its WTO accession; on the other hand, its fledgling financial service industry is far from ready to compete with foreign financial institutions. Actually, the under-development of the financial sector has become a kind of bottleneck for China's economy.[328] China's experience in carrying out its open door policy over these years has been a balanced approach which combines the opening to foreign participation and the cultivation of alert self-reliance. Liberalization of the financial sector also entails two integral aspects: while committing to foreign participation in the financial sector, the Chinese government should break up the State-owned financial institution monopoly and allow privately-owned enterprises to enter the financial sector and directly compete with state-owned financial institutions so as to foster the international competitiveness of the national financial institutions.[329]

[327] Ding Yifan, *Da Chaoliu – Jingji Quanqiuhua yu Zhongguo Mianlin de Tiaozhan* (Beijing: Zhongguo Fazhan Chubanshe, 1998) at 45-46.
[328] Long Guoqiang, *Zhongguo Fuwu Maoyi* (Beijing: Zhongxin Chubanshe, 1995) at 27.
[329] Since 1980 China's private sector growth has been especially dynamic with an average of 71 percent per year in terms of output and 41 percent in terms of new employment. By 1998 the domestic private sector had grown to about 27 percent of China's GDP. Notwithstanding the growing importance of China's private sector in China's economy, it has not received comparable treatment. Many small and medium-sized firms are in dire need of capital to expand and renovate, but they basically can not get loans from state-owned banks, which now direct their loans to state-owned enterprises. Now that China is scheduled to open its banking sector to foreign banks, there seems to be no reason to exclude China's private enterprise from entering this sector and it is high time for China to allow the establishment of private banks in China to serve the needs of private enterprises. At present there are certain signs indicating that China will relax bans on private sector entry into its banking sector. In July 9, 2000, Daniel Dianqing Xu, from the University of Western Ontario, together with some well-known domestic and overseas Chinese economists established the Great-wall Financial Research Institution in Xian, aiming to conduct feasibility researches

B. Market Discipline and Competition Rules – anti-trust in China's financial market

UNCTAD first addressed the issue of competition policy in its 1996 "World Investment Report." The health of an economy not only lies in its liberalized trade and investment mechanisms but also in a pro market competition environment.[330] The financial market is a market with a high entry cost and a limited number of players. If there exist no proper regulations for activities such as acquisitions, mergers, joint ventures, market competition may be reduced or strangled. The task of legislation is to find a balance between control and free competition. In China's financial market, on the one hand, the few state-owned banks and insurance companies actually enjoy oligopoly positions in China's financial market; on the other hand, with China's access to the WTO, foreign financial institutions will rush into China's market and acquire dominant positions in some services given their great advantages in the variety of service products and in innovation.[331]

At present China have a simple "Anti-unfair Competition Law," enacted to address unfair competition concerning the infringement of intellectual property and the abuses of monopoly position by public utilities. It failed to address the core content

concerning establishment of private banks. They selected 5 regions which represent different development models of China's private enterprise system as their research target. According to Professor Daniel Dianqing Xu's view, the form of the private bank is a joint stock company with a ceiling of 10% of the equity for each shareholder. The investors should be strictly limited to private enterprises and a deposit insurance system should be set up to guarantee the operation of private banks. However, the official stance in this regard is still quite vague, which somewhat reflects the divided opinions in the Central government.

[330] See online at: <http://www.unctad.org/en/pub/ps1wir96.htm> (date accessed: 29/04/2001).

of anti-trust laws such as market structures, mergers and acquisitions, joint ventures, monopolies, and abuse of dominant positions on the part of commercial enterprises.[332] Most developed nations in APEC have enacted comparatively sound pro competition laws. Even some developing countries such as Malaysia and Indonesia are in the process of devising their own competition laws. Because China's economy is in the process of transformation from a command economy to a market economy and there are certain critical unsolved problems such as the dominance of state ownership, Chinese legislators are still reluctant to enact anti-trust laws to eliminate state financial institution oligopolies or monopolies. However, according to GATS, the "Understanding on Commitments in Financial Services" 1997 and China's commitments, China must gradually remove all restrictions on foreign competition. Therefore, it is high time for Chinese legislators to enact their own anti-trust laws.

Anti-trust laws will not prohibit dominant positions in themselves but only their abuses, which will result in restriction of competition or distortion of competition. Under certain circumstances, combination can lead to efficiency. With the progress of financial globalization, the legislation of anti-trust laws should not be based solely on domestic markets; it should also be based on the interaction between international markets and domestic markets. Transnational mergers and acquisitions will not necessarily lead to monopolies in domestic markets; rather they can boost

[331] AIG grabbed 45% of Shanghai's life insurance market within 2 years and relied upon simple tactics such as door by door promotion.
[332] Cheng Kaiyuan, "Fan·Buzhengdang Jingzheng de Jidian SiKao" (1998) 23 Journal of Nankai University 76 at 78-80.

the international competitiveness of these merged financial institutions. The fact that many super transnational financial institutions have sprung up through mergers since the 90s reflects the adjustments of anti-trust laws in developed countries to foster the international competitiveness of their financial institutions.[333] The oligopoly or monopoly of China's state financial institutions is primarily the legacy of a command economy. China should transform the "big four" into real commercial banks and introduce competition between them. At present, China's 102 joint stock banks (including city commercial banks) account for 13.6% of the total assets of China's financial institutes.[334] Although they are still not comparable to the "big four" in size, they have the potential to compete with the "big four" because of their better assets quality and their efficiency.[335] However, it is not realistic and wise to divest state-owned financial institutions since China needs to improve the international competitiveness of its financial institutions. Given China's lack of experience in anti-trust legislation, it is not practical to expect its first draft to address all the issues pertinent specifically, and more room should consequently be left for the courts' discretionary power. In any case, by the time China has phased out all its restrictions regarding foreign participation in the services sector five years after its accession to the WTO, China should have

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[333] Li Huiming, "Meiguo Cong Xinjingji Zou Xiang Ershiyi Shiji Jingji" *Guoji Shangbao* (01/09/1998).

[334] Dai Xianglong (governor of PBOC), "Woguo Gufenzhi Yinhang Yao Xunqiu Xin Tupo" *Xinhau News Agency* (08/03/2001).

[335] That the assets quality of stock banks is better than the "big four" is partially due to the fact that they were set up much later than the "big four." Actually, some have begun to show the same symptoms suffered by the "big four" since they also belong to state-owned enterprises and their managers are similarly appointed by bureaucratic officials. The bankers will never worry about the performance of their banks as long as they can satisfy the officials. Absence of lucid ownership and residual claims, as well as a professional bankers market will make China's banks almost impossible to operate according to market principles.

developed a complete anti-trust law.

C. Universal banking or separate banking

China has adopted a compartmentalized approach in regulating different parts of the financial sector.[336] As a result, financial institutions in one of the three sectors – banking, insurance and securities - can only operate within the designated sector and can not mingle its operations with the other sectors.[337] While the US – once the only major country that adopted a separation model - repealed the Glass-Steagall provisions in the US Banking Act of 1933, which had restricted the power of commercial and investment banks to enter into one another's business and limited the connections between commercial and investment banks, China's decision to adopt a strict separation model is an interesting one.[338] Consequently, what are the principal reasons that have pushed China to adopt a strict separation model?

Just as the US enacted the Glass – Steagall Act to remedy the speculative abuses that infected commercial banking prior to the collapse of the stock market, China adopted the separation model to curtail the influx of funds backed by state-owned banks from entering China's fledgling stock markets. China's stock markets have

[336] The PBOC is responsible for the banking sector; the CSRC is in charge of the securities market; the CIRC regulates the insurance sector.
[337] Article 43 of the *Commercial Bank Law* enjoins commercial banks not to participate in non-bank financial activities such as participation in the trust and securities business, or investing in real property that is not intended for the banks' own use within China; article 104 of the *Insurance Law* prohibits insurance companies from using its funds to set up securities firms or brokerages or to invest in enterprises; article 6 of the *Securities Law* clearly stipulates that stock firms, banks and trust firms, and insurance companies shall operate separately and be administered separately. Moreover, stock firms, banks, trust firms as well as insurance companies shall also be established separately.

been characterized by over-speculation and volatility.[339] It is believed that in the middle of the 1990s speculative funds amounted to about RMB 400 in China's stock and futures markets.[340] Most of these funds were from the state owned banks in the form of loans and/or investments by the TICs with affiliations to these banks. Such practices coupled with moral hazard problems that are prvalent in China's financial sector greatly augmented the possibility of huge losses and financial panics.[341] Implementation of the separation model somewhat curbed over-speculation concerning China's stock market, but it also resulted in certain negative results. First, with important clients of the banks going to the stock market to raise funds, the banks increasingly found it difficult to find outlets for their growing deposits; secondly, private banking services, which first appeared in the US in the late 1970s, represent one of the major businesses in the banks of developed countries. Private assets in China have snowballed over the years.[342] Because of the poor performance of the SOEs, the Chinese banks have begun to turn to this new form of business which is more profitable. The advantage of banks in this connection lies in their ability to provide comprehensive private banking services ranging from personal trusts, financial planning to investment management.

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338 On Nov. 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act, which repealed the Glass-Steagll Act, online: <http://www.moneymanagerservices.com/News.02-01-2000-1.cfm> (date accessed: 30/04/2001).

339 Professor Wu Jinlian, a well-known Chinese Economist described the Chinese stock market as a big casino.

340 Foo Choy Peng, "Regulators Desperate for Hot Money Solution: High-Yield Seekers Wreak Havoc" *South China Morning Post* (July 12, 1995) 6.

341 Because of the dominant state ownership in China's financial sector, the financial institutions are actually empowered to operate and dispose of the assets that do not belong to them with all the rights that a property owner possesses. Therefore these institutions tend to be eager to speculate. Just as one of J.P. Morgan's economists commented, China's financial institutions did not risk their own money. Whatever they make, they keep. Whatever they lose, the government takes care of.

342 In some coastal provinces, the volume of private business takes up nearly half of the local economy.

However, the separation of banking and securities has greatly limited the ability of China's banks to provide their clients with a complete investment package and is has consequently hindered their business expansion in this area.[343] Thirdly, with the effective implementation of the separation of banking and securities, the liquidity of China's stock market shrank greatly. The ratio of the average daily turnover to market capitalization of China's two stock exchanges fell from 0.72% in 1997 to 0.49% in 1998 and 1999. The funds raised from the stock markets also declined from RMB 129.4 billion in 1997 to RMB 83.7 billion in 1998.[344] Fourth, under the separation model, China's insurance companies are also in dire need of investment outlets. The Insurance Law restricts insurance companies' investment to bank deposits, the trading of government bonds, financial bonds and other means stipulated by the State Council. Five consecutive interest rate cuts by the PBOC during 97-99 made some depositors turn to life insurance as an alternative and boosted the business of life insurance companies. However the limited means of investment give rise to doubt about the insurance companies' long-term repayment ability. This could engender an insidious and deep crisis in China's insurance industry.

Actually, the Chinese government has adopted the separation model based on the scenario that state owned banks possess a dominant position in a closed financial market. With China's upcoming accession to the WTO, China should reconsider its

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[343] Wu Yinqiang, "Geren Jingrong Zonghehua – Woguo Shangye Yinhang Fazhan Lingshouyie de Xianshi Xueze" *Jingrong Shibao* (16/12/1998) at 3.
[344] "China's Stock Market Reform"(2000), online: < http://www.tdctrade.com/econforum/citi/001101.htm> (date accessed: 30/04/2001).

policy in this respect. With the progress of financial liberalization, financial regulators in developed countries have shifted the supervisory emphasis from business restrictions to financial control.[345] This represents an institutional change in financial legislation: previously the regulators reduced financial risks by insulating the financial institutions from certain forms of business; nowadays the regulators relieve financial risks through encouraging competition and hence reinforce the capacity of financial institutions to sustain and overcome risks. Germany, Austria, Switzerland and other continental European countries have few limits on their banks' scope of business. The US, the UK and Japan, which once adopted the separation model between banking and securities business have now all turned to universal banking. It is clear that universal banking represents the future direction of banking reforms.

Some scholars argue that the separation of the banking and securities business could realize the goal of stabilizing financial markets and The Glass-Steagall Act played a critical role in stabilizing and standardizing the US financial market.[346] However, some others argued that the enactment of the securities system, not Glass-Steagall, was the single most important factor in curtailing abuses in the securities business.[347] While many developed countries have been busy developing a supervisory system that can lower financial risks while increasing efficiency, China

[345] Financial control generally includes control of the ratio of capital adequacy, the ratio between the balance of loans and deposits, the ratio between the balance of circulating assets and circulating liabilities and certain other ratios. See *Mao Hongjun, Zhongguo Jingrong Tizhi Gaige Xinjucuo* (Beijing: Beijing University Press, 1994) at 73.
[346] Don More, "The Virtues of Glass-Steagall: an Argument against Legislative Repeal" (1991) 1991Columbia Business Law Review 433 at 441.

should also gain a broader vision in this regard. A scrutiny of the reasons resulting in the debacle of the US stock market in 1929 may reveal that the Banks' involvement in the securities is only a superficial cause. The ulterior reason lies in the primitive stage of the financial markets, under-developed institutional investors, the irrationality of investors, and inexperience in financial supervision. However, people were caught in the panic and regarded involvement of banks in securities market as reasons for the collapse of the stock market since they had neglected the effect of diversified portfolios in relation to lower financial risks.[348] Actually, the involvement of banks in the securities and insurance sector does not necessarily entail high risks. The operation risks of banks are mainly determined by their knowledge of the risks and the level of internal management and external supervision. Banks in Germany have participated in securities markets and held stocks in enterprises a long period of time; however, their bankruptcy rate is much lower than those in the US and Japan which once followed the separation model. With improved internal and external risk control measures, universal banking can provide its clients with optimum investment options, strengthen the connections between banks and their clients, and stabilize the financial system.

China has relaxed some of the restrictions on the separation operation between banks, securities and the insurance sector.[349] With the improvement in internal

[347] William M. Isaac & Melanie L. Fein, "Facing the future: life without Glass-Steagall", (1988) 37Catholic University Law Review 280 at 289.
[348] *Ibid.*
[349] In 1999 the PBOC lifted the ban prohibiting banks from financing stock markets. Some selected securities firms and fund management companies have been allowed to borrow from the inter-bank market for a maximum tenor of 7 days. Beginning October 1999, insurance companies could invest a

management of China's banks and the supervision ability of the PBOC, China should gradually follow the universal model.

PART IV, CONCLUDING REMARKS

Trade in financial services and the liberalization thereof are sensitive and complicated issues in the international sphere of trade law. Trade in financial services is closely related to foreign direct investment and the liberalization of financial markets that involves the liberalization of capital account of a country. Policies regarding capital account control are crucial for a country to realize its macro-economic and social goals. Therefore most countries are very cautious in making their commitments in this sector.

GATS signifies that trade liberalization has been expanded from goods to services. The series of negotiations and conclusion of the Understandings and Protocols represent the establishment of a legal framework for trade in financial services, which is the result of a compromise among states following different interests. Liberalization of financial services will no doubt benefit those countries with advanced financial service industries the most. For developing countries, such liberalization is the necessary price to be paid if their financial industries are to reap their legitimate rewards.

All the GATS general principles are applicable to trade in financial services. But

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portion of their premium receipts in mutual funds for an amount up to 15% of their total assets upon approval of the CISC.

when the MFN, the NT and market access principles commonly applied in trade were applied to financial services they acquired some of the unique features proper to financial concerns. Reciprocal condition once loomed as a big problem, but with the improved commitment of the emerging market economies which the developed nations have an interest in, the prospect of an eventual unconditional MFN and a full NT became bright.

China's financial markets are under-developed and problematic. The stock market is volatile and basically a place in which the SOEs can devour capital; the banking sector is dominated by the "big four," which are heavily troubled by the non-performing loan problem and lack of adequate techniques and efficiency; the insurance sector is also characterized by state monopolies.

Foreign participation in China's financial markets is still limited. Only a handful of foreign banks are allowed to engage in RMB business in a restricted geographic area. Foreign participation in the insurance sector is basically restricted to Shanghai and Shenzhen and foreign participation is excluded from China's A share markets. However, due to the great potential of this market, many foreign financial institutions have set up representative offices and branches in China, awaiting the inevitable opportunities ensuing upon China's access to the WTO.

China's commitments in the China-US and China-EC WTO access agreements are more than generous. Nonetheless, China realized that it was far from ready to open its financial sector. Commitments are one thing, living up to these commitments is quite another. Unless China can complete its financial reform within five years, it will be exceptionally difficult for China to live up to these commitments. What China expects is to stand still in relation to these commitments and to postpone WTO access for several years. However, for those foreign financial institutions that have been waiting to enter China's financial markets for this long, any procrastination is fraught with difficulty. Some congress members in the US threatened to reconsider China's PNTR if China could not wind up WTO access negotiations by June. Reluctant as it now is, the Chinese government will try to complete the bilateral negotiations and other documents required for WTO membership by the end of 2001.

The liberalization of China's financial market is only one aspect of China's integration into the international financial market. To become a real player in the international financial market, China should be determined to develop its national financial industry by relaxing restrictions on private sector entry into the financial sector, thereby creating a level ground for all the players in the financial sector. Universal banking represents the future direction of banking development, and China should at least permit certain pilot projects in selected coastal cities to gain sufficient experience to effect the ultimate transformation of its financial sector.

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