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anton.malkin@gmail.com

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Agents of Change: The Role of Foreign Financial Institutions in China's Financial  
Transformation Since the early 1990s.

by

Anton Malkin

DOCTORAL DISSERTATION

Submitted to the Department of Global Governance in the Faculty of Arts

in partial fulfillment of the requirements for the Degree of:

Doctor of Philosophy in Global Governance

Wilfrid Laurier University

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Supervisor: Eric Helleiner

Committee: Hongying Wang, Gregory, T. Chin, Randy Wigle

External Reviewer: Justin Robertson.

## **Thesis Abstract**

What role have foreign financial institutions (FFIs) played in China's financial evolution since the early 1990s? My research finds that FFIs, which include foreign commercial and investment banks, as well as private equity (PE) firms, have played a role in China's financial evolution in three respects. First, US financial institutions have leveraged their influence in the US government, their ties to other business groups, and mobilized connections with the Chinese elite, to help China to join the World Trade Organization in 2001. This outcome created a relatively open formal, legal environment to foreign actors—helping in the cause of liberalizing China's financial system. Second, and much more significantly, FFIs have aided in Premier Zhu Rongji's push to reform the Chinese banking system and state-owned enterprises in general by creating linkages between the Chinese state and global finance and, in the process, helping to create a vast market of overseas Chinese equities in Hong Kong, New York, and elsewhere. Thirdly, and also very consequentially, FFIs trained Chinese financial professionals and precipitated the flow of 'returnees'—Chinese professionals returning to work in the Mainland after studying finance in Anglo-American institutions and moving on to work in finance on Wall Street, London, and Hong Kong—back to the Mainland, where the latter collaborated with Chinese officials to build up a native PE industry. In this way, FFIs have also helped to transfer Anglo- American financial expertise to Mainland China.

By helping Chinese policymakers to use Anglo-American financial expertise to reform corporate finance, banking, and private equity, not to mention insurance, investment banking, and a host of other sub-industries, as well as to fund Chinese SOEs and state banks in their time of need (in the late 1990s and early 2000s)—and to do so while maintaining state ownership over these enterprises—FFIs have, ironically, precluded the need for policymakers to give them a greater role in China's domestic financial system. This process alludes to Vernon's (1971) notion of

obsolescing bargaining. From a theoretical point of view, FFIs' role can be seen as one of internationalizing China's financial system, not liberalizing it. I define the concept of internationalization as a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as global cities or production chains. This is described as being distinct from liberalization, which implies the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition.

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Many thanks as well to Mark Krueger and Sanja Panday at the Canadian Embassy in Beijing for the insightful conversations on China's financial system and for the many initial contacts that helped to get my field research off the ground. Many thanks to my great friends in Beijing, who helped me to settle down and make the city my home for over a year and a half. Thank you, 成慧, 成聪, Tomas Granqvist, and anyone else that helped me to adapt to life in Beijing. Thanks is also owed to Logan Wright for the many great conversations on China's financial system, which helped me to make an important transition in the direction of my field research.

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But the greatest share of gratitude is owed to my wife, Aileen Pou. To say that I could not have done this without her constant support and encouragement would be an egregious understatement. To her, I dedicate this work.

**Author's Declaration:** I hereby declare that I am the sole author of this dissertation. This is a true copy of the dissertation, including any required final revisions, as accepted by my examiners. I understand that my dissertation may be made electronically available to the public.

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## **Agents of Change: The Role of Foreign Banks in China's Financial Transformation Since the early 1990s.**

### **1.0 Introduction**

China's financial system has undergone profound changes since the 1980s, when the banking system was little more than an administrative network set up to fund the activities of state-owned enterprises (SOEs) (Lardy 1998). Private enterprises had had to rely on underground, "back alley" money lending institutions and friends and relatives to gain access to export credits and to finance daily operations (Tsai 2004). One need not be a China scholar or historian to appreciate the monumental scale of the change. In the early 1980s, much of the system was administered by communist party officials that met administrative credit targets meant to help SOEs achieve production targets set out in Five Year Plans. By the mid-1990s, China's Communist Party leader had legalized and institutionalized what it once denounced as the capitalist or imperialist idea of financial intermediation.

Interbank lending, financial instruments, and other traits of market-based banking were legalized under the framework of building a "socialist market economy." By 1995, The National People's Congress (NPC) formally recognized financial trading, initial public offerings (IPOs) and investment banking; the same year NPC also wrote into law that "Commercial banks shall make their own decisions regarding their business operations, take responsibility for their own risks, assume sole responsibility for their profits and losses and exercise self-restriction" (Legislative Affairs Commission of the Standing Committee of the National People's Congress 1995, p. 2). In 2001, China acceded to the World Trade Organization (WTO), formally opening itself to trade in financial services. By 2004, the newly formed China Banking Regulatory Commission (CBRC) standardized and regulated financial derivatives. These were monumental institutional changes that recreated both direct and intermediated finance: something that had hitherto been shut down for over forty years. A lesser known promulgation passed by the CBRC that year allowed foreign

financial institutions (FFIs) to buy up to 20 percent in the equity issues by state-owned banks, with total foreign ownership capped at 25 percent.

There are a number of characteristics that define the Chinese financial system. First, China's financial sector is dominated by the state-owned commercial banks, with the Industrial and Commercial Bank of China (ICBC), the Bank of China (BOC), Agricultural Bank of China (ABC), China Construction Bank (CCB) and the Bank of Communications (BOCOM) making up a disproportionate share of financial assets—nearly 40 percent, according to recent estimations (Lardy 2014). City and provincial government-owned joint-stock commercial banks make up another large share of financial assets, with equities, inter-bank finance and investment banking comprising a relatively low share by international standards (Chang and Lochel 2012). Financial capital—non-bank, disintermediated finance—remains relatively low in proportion to bank-based finance, leading many to characterize China's financial system as one defined by 'financial repression' (Shambaugh 2008; Vermeiren and Dierckx 2012). The state remains in many ways at the 'commanding heights' of banking and finance (Grain 2015) and capital allocation in general remains state, rather than market-driven (Nolan 2010).

At the same time, informal and direct, peer-to-peer (P2P) finance is on the rise, making up an increasingly significant part of the financial system, with some research even pointing to the increasingly important role of private banks and non-bank financial institutions (Lardy 2014). Moreover, while the state plays a key role in allocating financial capital in the economy, market-based financial regulation, central banking, and profit-oriented lending decisions basically define the Chinese financial landscape (Steinfeld 2010). And while in equity finance, the domestic stock markets are dominated by politicized stock issuance and investment, and by a lack of retail investors (not to mention insider trading and outright corruption), the country still claims sovereignty over one of the most liberalized financial centers in the world: Hong Kong. The city off the southern coast of Guangdong province boasts a great variety of Mainland Chinese company shares—public and private companies alike—and therefore hosts a parallel, globally-integrated financial system

that has played an important role in raising capital for, and restructuring, Chinese state-owned enterprises and banks (Walter and Howie 2012; Gillis 2014). Regardless of what one thinks of the nature of China's present-day financial system (and there are many competing views on the subject), it has come a long way from what it looked like up until the 1990s, at which point the system still functioned as an indirect way of channeling public budgetary funds to locally-owned state enterprises, and doing little else.

While it is not the goal of this thesis to recount, in full, the evolution of China's financial system since the start of the reform era in China, it is one of my goals to note the absence in many discussions of China's financial evolution of the role of foreign financial institutions. This is far from surprising: in the present day they control no more than two percent of the total banking assets in China's financial system (The Economist 2014), and no more than one percent of total stock market capitalization (Stephen 2012). Moreover, unlike in some Latin American countries or in post-communist Eastern Europe (excluding Russia), which have seen FFIs buy up failing and poorly performing banks and other financial institutions and exert an *overt* influence on financial development in these economies, they have largely been confined to a complementary role in China's financial system. But looking at the role of FFIs in China from the perspective of market share is highly misleading. The research presented in this thesis shows that FFIs have, contrary to this assessment, which often portrays FFIs as niche market actors in China (e.g. Oliver Wyman 2012), I will argue that FFIs' role in China's financial evolution since the early 1990s has been more significant than is often acknowledged. While we cannot say that FFIs have been involved in the creation of every single characteristic of China's present day financial system, as described above, their participation in China's financial reforms has helped to define China's commercial banking, equities markets, and newly-emerging sectors like private equity into what it is today.

This thesis seeks to answer the following question: What role have FFIs played in China's financial evolution since the early 1990s into the system that defines its financial landscape today? My research finds that FFIs have played a role in China's financial evolution in three respects.

First, US financial institutions have leveraged their influence in the US government, their ties to other business groups, and mobilized connections with the Chinese elite, to help China to join the World Trade Organization in 2001. This outcome created a relatively open *formal*, legal environment to foreign actors—helping in the cause of liberalizing China’s financial system. Second, and much more significantly, FFIs have aided in Zhu Rongji’s push to reform the Chinese banking system and state-owned enterprises in general by creating linkages between the Chinese state and global finance and, in the process, helping to create a vast market of overseas Chinese equities in Hong Kong, New York, and elsewhere. Not incidentally, FFI’s efforts also helped to establish Hong Kong as a Chinese offshore financial centre, and a specialized and highly internationalized global city by piggybacking on the experimentation of local brokerage firms and the policy changes undertaken by Hong Kong’s policymakers. Thirdly, and also very consequentially, trained Chinese financial professionals and precipitated the flow of ‘returnees’—Chinese professionals returning to work in the Mainland after studying finance in Anglo-American institutions and, working in finance on Wall Street, London, and Hong Kong—back to the Mainland to secure deals with Chinese officials FFIs have helped to transfer Anglo-American financial expertise to the Mainland. While the localization of Anglo-American financial expertise has stopped far short of a full acquiescence in foreign knowledge and practices, the ways in which this knowledge has become adopted and changed to suit China’s political economy also stems from the way that it was transferred to China by FFIs. By helping Chinese policymakers to use Anglo-American financial expertise to reform corporate finance, banking, and private equity, not to mention insurance, investment banking, and a host of other sub-industries, and to fund Chinese SOEs and state banks in their time of need (in the late 1990s and early 2000s)—and to do so while maintaining state ownership over these enterprises—FFIs have, ironically, precluded the need for policymakers to give them a greater role in China’s domestic financial system. This also allowed Chinese policymakers to postpone financial liberalization in the Mainland. This outcome references

past and present literature on obsolescing bargaining outcomes in Multinational corporation (MNC)-host government interactions (Vernon 1971; Vivoda 2008; Eden et al 2005).

My thesis further suggests that to understand the role played by foreign financial institutions in *internationalizing* China we can borrow from existing scholarship on the concept of internationalization, as an outcome of interactions between domestic politics of a country in question and global markets and global economic norms and practices. I outline the theoretical and empirical work in Keohane and Milner (1996), Schlichting (2008) and Zweig's (2002) application of their studies and theoretical conceptualization to the case of China (with Schlichting focusing specifically on FFIs). I offer a critique of this literature and, drawing on the work of Gallagher (2011), and Huang (2003; 2008), I make a distinction between liberalization, which is defined as the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition, and internationalization. I posit that internationalization does not necessarily include the removal of such barriers. I define the concept of internationalization as a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as global cities or production chains. Following Keohane and Milner (1996), I suggest that the changes produced by the process are driven by altered incentives and transaction costs, but that the process is actually a deliberate project of policymakers, who choose which actors and institutions are exposed to the global economy, and the ways in which they are exposed thereto. I suggest that this definition provides a useful and generalizable framework for understanding China's interactions with FFIs and the obsolescing bargaining outcome references above. I draw on a number of studies in IPE and China studies—most notably Steinfeld (2010), Robertson (2015) Sassen (2011), and Palan (1998) to suggest that in the case of China's interaction with FFIs we see this process carried out through two linkages: elite-based and spatial linkages.

The chapter will proceed in the following way. Section 2 will outline the methodology used in conducting the research for this thesis. Section 3 explains how the aforementioned role of FFIs

in China's financial evolution has played out since the early 1990s. It will, in effect, summarize the story told and the argument made in chapters 2 through 5. Section 7 will then introduce the theoretical concepts that will be explored in chapter 1.

## 2.0 Methodology

The methodology used to conduct the research for this thesis has been qualitative. In addition to synthesizing existing, secondary literature, which often mentions but does not explore in depth the role of FFIs in the process of China's financial reform, the thesis relies on 3 different sources to substantiate the case outlined above. First, it constructs a narrative of the role of FFIs in China's financial evolution by examining financial media in English and Chinese, as well as using firsthand accounts of FFI managers that participated in the events describes here. The most significant of these accounts are Goldman Sachs executive Henry Paulson's *Dealing With China*, which includes an extensive narrative of accounts from his years making deals for Goldman in China, as well as Maurice Greenberg's *The AIG* story, which includes accounts of his experience in working with Chinese officials in the 1990s, when his company sought to open and develop China's insurance markets. While these accounts are not objective, they are supplemented with media reports and data where possible. Additionally, they are not used with the goal of establishing objectivity, but rather to provide a first-hand perspective of China's financial evolution through the eyes of FFIs themselves.

The second type of source used in my research is specific to chapter 4 of the thesis. As will be described in the next section, chapter 3 explores FFIs' views of China's financial landscape through a content analysis of American and European Chambers of Commerce publicly available annual reports. It uses these documents to categorize and visualize the various grievances raised by FFIs working in Mainland China between 2006—the year that China's WTO compliance phase-in



period was concluded—and 2014. Additionally, it supplements incomplete or weak information in these documents with industry reports published (almost) annually by PriceWaterhouse Coopers (PwC) titled *Foreign Banks in China*. The goal here is to establish that FFIs' efforts in lobbying China (through the US government) to lift formal barriers to foreign participation in China's financial system have not been in vain; that largely, formal institutional barriers have come down. The grievances show, however, that FFIs' role in helping the Chinese state to maintain commanding heights over finance by helping to restructure SOEs and banks and raise capital for them in overseas financial markets has contributed to erecting systemic obstacles to FFI participation in the Mainland financial system. Chapter 4 will outline the methodology and reasoning in more detail.

Lastly, this thesis also cites 11 semi-structured interviews with FFI managers, financial journalists, chambers of commerce representatives, and a foreign diplomat, conducted between September 2012 and July 2013 in Beijing, Shanghai, and Hong Kong. The purpose of these interviews was to supplement any gaps in documentary evidence, financial media reports, and FFI managers' firsthand accounts that made it necessary to "connect the dots" in my research—to build a strong and sufficiently convincing narrative about FFI's role in China's financial reforms. The names of the interviewees, the names of the institutions they have or currently work for are not revealed. Only the date of the interview is noted in the citations throughout this thesis. The information from which the citations were drawn is stored in a single notebook that was used to record essential information from the aforementioned interviews. As per the research ethics policy stipulated by Wilfrid Laurier University (REB 2012), only myself and my supervisor (upon his request) can have access to these notes. In agreement with the Wilfrid Laurier research ethics stipulations, the interviews conducted for this thesis comply with the Tri-Council policy on Ethical Conduct for Research Involving Humans (Tri-Council 2014, pp. 6-9).

The research presented is rooted in the methodology of process tracing (see Collier 2011; Bennett and Checkel 2012; George and Bennett 2005). The method is defined by four distinct

characteristics: analysis of decision-making processes and events that occur *within* case studies (so as to be distinguished from big *n*- quantitative analyses or comparative, multi-case studies); the use of both qualitative (e.g. interviews, events as reported in the media, and government/organizational documents) and quantitative data (e.g. coded media content, demographic or economic metrics, and statistical data gathered by governments, international organizations, etc) to test a hypothesis by describing a processes through which outcomes take place; the description of how agents or actors operate in a specific context, rather than across multiple contexts; and making causal inferences based on the complex interaction of causal factors, which often involves making implicit or explicit counterfactual assumptions about outcomes that occur at ‘smoking gun’ intervals in the narrative being described (Blatter and Haverland 2014).

My research uses process tracing to construct a narrative of FFIs in China since the early 1990s. The rationale for this methodology is threefold. First, my research is, effectively, based on one case study: the role of FFI’s in China’s financial system. While the four empirical chapters provide different cases illustrating FFIs’ role in this regard, they are essentially sub-cases, better understood as sub-narratives. It may have been possible to construct the empirical evidence as a comparative political economy of different FFIs, but this would have made for a much less robust illustration of how FFIs influence China’s financial evolution. In effect, investment banks and private equity companies would be vastly overrepresented, while commercial banking institutions would receive much less rigorous treatment. Commercial banking institutions were almost completely absent from the outsourcing of equity market developing and lobbied largely in consortium with other FFIs. Insurance companies too had kept a much lower profile, being active largely in the lead-up to the WTO accession phase. The case of PE firms could not be given individual treatment because this case would rely far too heavily on Robertson’s (2015) work on the subject. Although my focus is different from that of Robertson, there is too much empirical overlap to allow for a stand-alone chapter on the subject.

Second, a large-*n* quantitative study would not be possible for the kind of research I set out

to conduct. I judged it unfeasible to construct quantitative measures of my dependent variable, the evolution of China's financial system, because the goals of my investigation were qualitative in nature. My research delves into development of China's state-owned enterprises (as it pertains to financial system reform), the development of overseas markets for Chinese equities, China's WTO accession, the lobbying by FFIs of the Chinese government and its regulatory agencies, the retreat and the return of the state in China's financial system, the growth of the private equity industry in China, and the role of Hong Kong in China's financial evolution. The complex interaction of FFIs with these historical developments merits the use of process tracing as opposed to quantitative regressions, or game theory modeling not only because quantitative data is difficult to obtain, but also because the inclusion of all the relevant variables would render any potential regression model over determined, and any game theoretic equation too specific to be applicable in any case beyond this thesis. Moreover, any sufficiently objective data on FFIs role in China's financial system would actually under-state their significance.

To be sure, quantitative rendering of qualitative data was employed where it was deemed possible. Specifically, I coded the survey results presented in PwC *Foreign Banks in China* annual reports and in the US and European Chambers of Commerce annual position papers, in order to condense and simplify the inconsistent written representations of FFI views. Chapter 3 describes my coding methodology in more detail.

Lastly, process tracing was used because one of the contributions of my research to the existing China studies and international political economy literature is in giving a historical account of FFIs in China since the 1990s. So far, only Chen (2011) has catalogued FFIs experience in China. But Chen's account is largely anecdotal, and journalistic, lacking a guiding research question and theoretical framing. Moreover, much like Schlichting (2008), his account does not include what, as I have demonstrated, is an important part of the story: the story of Chinese equities in foreign stock exchanges. Moreover, Schlichting's (2008) work is not exclusively about FFIs, but about internationalization of China's financial system more broadly. Therefore, while modest in its reach,

the use of process tracing makes the most extensive contribution that my empirical evidence allows.

### **3.0 Thesis narrative and chapter outline**

#### *3.1. Organization and Overview*

This thesis will proceed in the following way. Chapter 1 (the following chapter) will outline the contributions of my research to existing international political economy and China studies literature. This chapter will also outline my theoretical contributions to the study of the internationalization of the Chinese state. Chapter 2 will look at the role of FFIs in China's accession to the WTO. It will examine how American and European FFIs leveraged their access to the US legislative processes, as well as their close relationships with Chinese policymakers to help bring the two sides closer to an agreement. This chapter will focus specifically on how FFIs relied on cross-issue alliance with other business associations and, and on their simultaneous linkages with American and Chinese policymakers (I term this 'triangular alliances'), to lobby for China's accession to the WTO. Chapter 3 will continue to explore the subject of FFI lobbying, but instead focus on the lobbying carried out in China, with a particular attention to how FFIs have tried to lobby Chinese policymakers after China's accession to the WTO. It will show how, following their successful push to help implement the formal, legal liberalization of China's financial services sector, their lobbying efforts have been, for the most part, ineffectual. I will argue that this was not the result of direct discriminatory measures taken by China's regulatory agencies but instead due to the following systemic obstacles embedded in China's political economy: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets. Chapters 4 and 5 will outline the ways in which FFIs have, ironically, contributed to these obstacles.

The first step in the FFI's role of helping to construct these systemic obstacles will be examined in Chapter 4, which will look at perhaps the most important role played by FFIs' in China's financial evolution: listing Chinese SOEs—non-financial SOEs as well as China's state-owned commercial banks—in overseas stock exchanges. This chapter will examine how China's policymakers segmented Chinese equity markets between Mainland ones and the foreign listed ones, beginning with Hong Kong. By helping Chinese policymakers to utilize international capital markets without radically loosening capital controls or lifting the ceiling on foreign ownership FFIs effectively precluded a greater role for themselves in China's domestic financial development. Chapter 5 will show how FFIs, then, willingly transferred Anglo-American financial expertise to China's financial sector by participating in joint venture (JV), equity-based 'strategic' partnerships, and by training Chinese financial professionals and precipitating the flow of Chinese financial returnees back to the Mainland. I suggest that the limits to role played by FFIs, as described in Chapters 3 and 5, is an example of obsolescing bargaining.

### *3.2. The Role of Each Chapter in the Broader Narrative*

Before 1994, FFIs were essentially barred from conducting business directly in China. The only exception was the AIG-People's Insurance Company of China (PICC) joint venture called the China America Insurance Company, which operated on a very limited basis (it was largely a good will partnership; see Greenberg and Cunningham 2013) and did very little business. From 1978 to 1994, China's financial system still mostly functioned under the rules of a Leninist command economy, with experimentation in the area of corporate debt and equity, stock markets, and market-based risk assessments and lending only beginning to make an appearance in the late 1980s and early 1990s. In 1994, however, the State Council passed important legislation that allowed financial enterprises funded by foreign capital to establish subsidiaries in Mainland China, granting licenses

to a handful of foreign banks to operate out of Shanghai. The law, titled “regulations of the People's Republic of China governing financial institutions with foreign capital,” subsequently amended in 2002, 2004, and 2006 to further lift restrictions on FFIs operating in China, was an important milestone in the history of external financial liberalization in China. It formally and legally recognized FFIs as legitimate institutions in China and set out regulations stipulating the scope of their business. After four decades of being forbidden from conducting any kind of business in China,<sup>1</sup> FFIs were granted more than a right to do business in limited jurisdictions. They were formally and legally recognized by the CCP.

However, foreign ownership of Chinese banks, the right to sell insurance, the right to buy and sell shares of Chinese companies, or ability to incorporate their business locally were still nowhere near the government’s agenda in 1994. But one year later, FFIs were handed their first opportunity to have input into the future of China’s financial system. 1995 was the year that the PBoC began to experiment with state-owned banking reform. As will be outlined in more detail in chapter 5, this was the year that PBoC officials began working with the World Bank’s private sector lending arm, the International Finance Corporation (IFC) to pilot banking system reform (IFC 2012). The idea was to bring in FFIs that would be willing to put up capital and time to help China’s state-owned banks import modern lending, risk analysis, and managerial techniques. In the same year, Morgan Stanley and the China Construction Bank (CCB) entered into a JV partnership to pilot China’s first investment bank.

These were milestones for FFIs in engaging with, and ultimately playing a role in, the evolution of China’s financial system. IFC’s role has arguably been pivotal in helping to shape the direction and nature of state-owned banking reform. As will be explored in more detail in chapter 5, its collaboration with and participation in the reorganization of a number of city-owned

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<sup>1</sup> That is, aside from some minor foreign exchange functions executed in relations between the PRC and other foreign governments and institutions. HSBC and Standard Chartered, who maintained offices, respectively, in Shanghai even after the PRC came to power, were the only two FFIs formally recognized to assist the PRC in such transactions.

commercial banks as well as its extensive consultations with officials in the PBoC that would later join the ranks of the CBRC, when the State-Council level regulator was created in 2003, allowed the Chinese government to test the grounds for what large-scale banking restructuring would look like. Additionally, it showed the government how market-based reforms could be carried out with only limited private sector and foreign involvement. Morgan Stanley's joint venture with CCB was also a key moment in the history of the role of FFIs in post-reform period evolution of China's financial system.<sup>2</sup> While Morgan Stanley's influence in the partnership may have been limited and ultimately sidelined by infighting (McGregor 2007), it was a pivotal moment for transferring Anglo-American expertise from FFIs to Chinese reformers (Laurenceson and Qin 2008). These experiments showed Chinese policymakers that foreign capital and expertise could be acquired without ceding managerial control to foreign capital.

Chapter 4 will show that in 1998 Zhu Rongji tested these waters in a more definitive way, by handing CCB head Wang Qishan the task of raising capital in Hong Kong for a pilot project for what would later become popularly known as China's massive, state-owned 'national champions.' The pilot saw the Ministry of Post and Telecommunications consolidate and centralize a collection of provincially owned telecommunications assets into a central government-controlled entity that was then called China Telecom (China Mobile, today). The IPO of China Telecom saw China decisively move ahead with SOE and financial system reform in the direction of the system that characterizes China's political economy today (Chen 2014; Paulson 2015). Henry Paulson (2015) recalls in his memoirs, from conversations with Wang Qishan, that Zhu Rongji bet his push towards market-based reform and internationalization (which included World Trade Organization [WTO] membership) on the success of China Telecom being accepted by global capital markets as a modern, profit-oriented corporation. That Goldman Sachs' leading role in restructuring the management of the SOE and selling the firm to global institutional investors (as well as retail

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<sup>2</sup> Unfortunately, I do not have sufficient empirical information to explore the Morgan Stanley-CCB JV as a case study. This is, admittedly, a limitation of the present analysis.

investors in Hong Kong and New York) As Chen (2014) demonstrates, this was also a pivotal moment in the debate between conservative and reform-oriented factions in the CCP, which eventually led to the compromise that saw China's largest state-owned enterprises partially privatized, re-structured, but remaining firmly in state hands. Walter and Howie (2012) argue that, as a result of their decisive role in overseas IPOs, FFIs—especially American FFIs—essentially 'created' the modern Chinese SOE. Chen (2014) shows that this might be an exaggeration, considering the role of central government economic planning officials in erecting institutional boundaries to the extent of marketization and privatization in China's state-owned sector. However, as Farhoomand (1999) has posited, at the very least, Goldman's role in the successful listing of China Telecom should also not be underestimated.

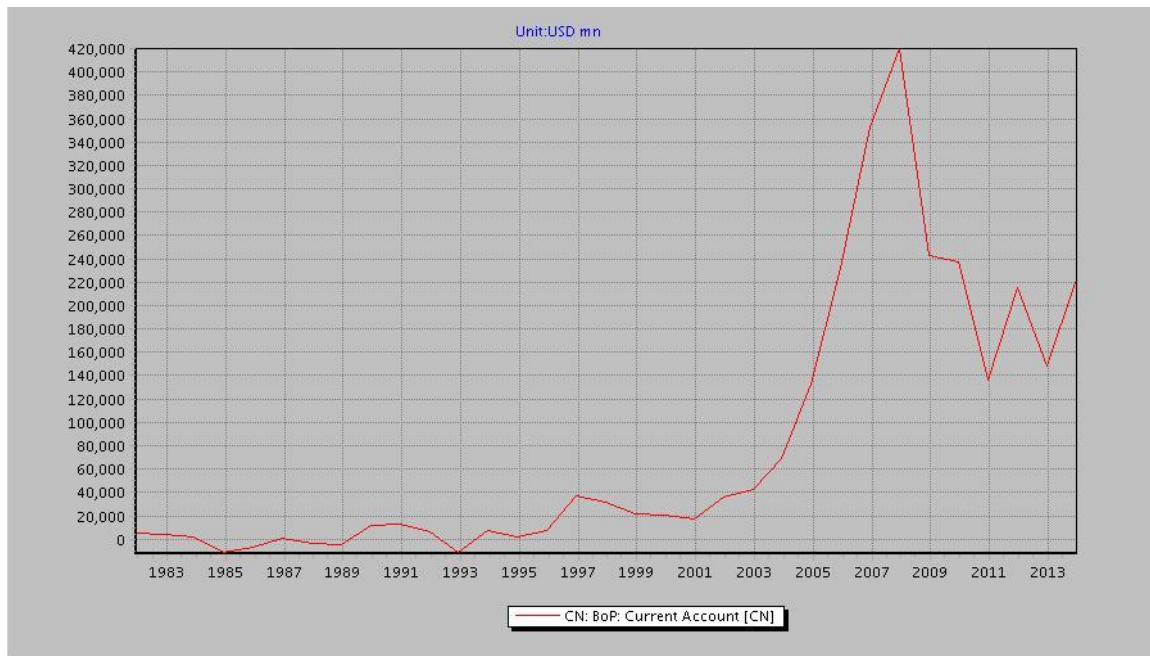
The deal-making of Henry Paulson, John Thornton, and Mike Evans, who took charge of the global listing in Hong Kong and New York, raised four billion US dollars in capital on a *promise* of future profits, going against the grain of the kind of financial analysis and profit projections that are typically required in such large-scale international listings. Ultimately, the deal-making skills of global financial giants such as Goldman Sachs, Morgan Stanley, HSBC, and others, proved to be essential for two reasons: 1) they raised sufficient capital to fund and legitimize SOE reform in the eyes of reluctant CCP conservatives and globalization skeptics (for an overview, see Fewsmith 2001a; 2001b)—to create profit-seeking state enterprises with management styles resembling publicly listed corporate enterprises in Western countries; 2) they effectively 'internationalized' China's financial system, by creating overseas equity markets (in New York, Hong Kong, and elsewhere) and allowed China's policymakers to access the international financial capital and expertise without having to rely on nascent and inefficient domestic equity markets.

These two observations might seem counterintuitive to contemporary observers of China's political economy. Today, the country's economy is characterized by a glut of capital, rather than by shortage thereof. But part of the reason that FFIs have been able to play a role in China's financial sector policymaking in the 1990s was that for the better part of the decade the country ran



only a modest current account surplus, and was actually in deficit in 1993 (see figure 1 below). As such, Chinese policymakers approached foreign investment banks not only for their expertise in organizing an effective IPO, their business savvy, and corporate finance/governance expertise, but for their ability to channel global financial markets to offer financing for Chinese SOE restructuring. However, I would caution against drawing direct causal inference between China's current account position and the degree of influence of FFIs in the 1990s (and conversely, the lack thereof from the mid-2000s thereon, when the country ran a very significant surplus), for two reasons. First, China's current account position is influenced not only by the availability of capital but by the role that FDI plays in generating output. In the 1990s, China was quite dependent on FDI in the manufacturing sector for its growth (see Huang 2003; 2008) and it was not until the 1997 East Asian Financial crisis that we can document a need for foreign capital with empirical certainty (this was largely a product of the collapse of China's export revenues, wide-spread private sector bankruptcies in the financial and manufacturing sector, and the spike in non-performing loans and effective bankruptcy in the state-owned banking system; see Walter and Howie 2012). Second, the listings of Chinese SOEs and banks in international financial centers continued well into the late 2000s and early 2010s, when China was at the height of its capital glut, which suggests a more complex array of motivations on the part of policymakers than would be inferred from a hypothesis that centers on China's need (or lack thereof) for foreign financing. Certainly, access to foreign financial capital is one variable that helped FFIs sell their services to Chinese policymakers in the 1990s and early 2000s, but it is not a variable that can be analyzed in isolation.

Figure 1. China's Current Account Position, 1983-2001.z



Source: CEIC 2016.

Chapter 4 also shows that Hong Kong, as an offshore, international city under Chinese sovereignty, also played a key role in ‘creating’ the modern Chinese SOE. While Goldman’s role in pioneering the ways in which global investors could be convinced to purchase equity in state-owned enterprises that were majority-owned by the Chinese government should not be understated, much of the early grunt work for restructuring and listing Chinese state-owned firms was actually performed by Hong Kong-based financial firms, in coordination with increasingly independent colonial authorities in the last years of British sovereignty over the island. To put it another way, FFIs piggybacked on the processes that were already in place.

Throughout the early 1990s, Hong Kong securities companies exploited a number of legal loopholes to allow Chinese state-owned utilities and energy companies to list on the city’s stock exchange. At the same time, the city’s policymakers passed laws to make exemptions to the city’s

strict listing requirements to allow Mainland enterprises<sup>3</sup> to list there. As Chapter 4 will show, this process of spatial internationalization allowed policymakers in (at the time) the PBoC to fast forward years, if not decades, into the future by not only raising capital in modern (in the Anglo-American tradition) and efficient capital markets without having to create them at home. Perhaps more importantly, it allowed them to expose Chinese state firms to the scrutiny of revenues and growth-oriented international investors, which put pressure on state-owned firm managers to change their incentive structures to be more profit-oriented. It also allowed Hong Kong-based FFIs to introduce Hong Kong and, later, international investors to the idea of buying Mainland firms. In this respect, Goldman merely perfected the practice in 1998. By then, Mainland firms already were already on the radar of equity investors across the globe, with a quantifiable country risk profile and even Mainland company indexes that were later adopted by large FFIs like Heng Seng and HSBC.

In 2001, China joined the WTO. Chapter 2 explains how FFIs leveraged alliances within the US business community and relationships with the CCP leadership to push for China's WTO membership, which included a number of key provisions to further external financial liberalization in China—specifically, to open up financial services to foreign firms. To be sure, due to a lack of strong empirical evidence linking such lobbying to policy outcomes, it is difficult to say precisely how important was the role of FFI in lobbying for China's WTO accession and for the inclusion of China's commitments on financial services therein. However, because existing literature has shown the US Business community to be influential in convincing the Clinton administration to conclude trade talks with the Jiang Zemin government (e.g. Devereaux et al 2006; Lampton 2001; Xie 2008; Roden 2003; Liang 2002) and because, as the chapter will illustrate, FFIs were important allies in

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<sup>3</sup> I hesitate to call pre-China Telecom IPO state-enterprises 'SOEs' because the corporate entities that we understand today to be Chinese government-owned corporations did not exist until Zhu Rongji's policy of 'grasp the large, release the small' began to be implemented (Hsieh and Song 2015). China Mobile's creation through the consolidation of provincial telecom assets, and its IPO in 1998 was essentially the pilot program for this policy (Chen 2014). Until then, Chinese state-owned companies functioned almost like government department rather than enterprises, or 'corporations' in the sense that we understand them.

the pro-Chinese WTO membership faction dubbed the ‘China Lobby,’ we can extrapolate that American FFIs’ role in China’s WTO accession was not marginal. Throughout the 1990s, US groups like US-China Business Council, the American Chamber of Commerce and, closer to the end of negotiations, the Financial Services Forum were quite active in media campaigns and congressional testimonies, making the case for permanently normalizing US-China trade relations.

At least in part, American FFIs’ efforts were not in vain: China has largely complied with the financial services section of the General Agreement on Trade in Services (GATS) section of the WTO agreement. To accede to the WTO, China agreed to country-specific stipulations to liberalize, among many areas of cross-border commerce, trade in financial services. It agreed to give FFIs the right to, among other things, incorporate their institutions in the mainland, conduct business in local currency, and to apply for branch expansion without arbitrary restriction. China’s record for implementing its WTO commitments (and doing so on time) has, from a legal perspective, been largely uncontroversial (Harpaz 2013) and post-WTO lobbying continue to see FFIs win some marginal lobbying victories, such as exemptions to China’s capital controls regime via the raising of the Qualified Foreign Institutional Investor (QFII) quota, through channels such as the China-US Strategic and Economic Dialogue (SED). However, as Chapter 4 will illustrate, for FFIs, WTO implementation effectively amounts to a kind of hollow form external liberalization. Ironically, FFIs’ important role in helping to shape the outcome of China’s financial evolution since the 1990s—through internationalizing Chinese equities, transferring Anglo-American financial expertise, and in helping to further Zhu Rongji’s push for external financial liberalization—has effectively strengthened the state-owned sector (especially in Mainland retail banking). It had the effect of precluding the necessity of FFIs’ capital and expertise in the mainland.

These findings partly support Walter and Howie’s (2012) hypothesis regarding foreign investment banks’ role in China, which posits that FFIs’ role in helping SOEs restructure and raise equity financing overseas precluded the necessity of liberalization and further reform after 2005. However, my research suggests that FFIs’ (which include foreign investment banks) role was more

modest and that—most importantly—available evidence does not suggest that their role in this process was paramount or more important than that of other actors, such as local and central policymakers, local Hong Kong brokerages, foreign accountants (see Gillis 2015) and even lawyers and consultant firms. Rather, my own findings simply suggest that the evolution of China’s financial system, which is presently defined by a high degree of state ownership, the dominance of bank-based lending (‘financial repression’), and a lack of development of equity finance (i.e. the latter being largely outsourced to global capital markets, with domestic reform moving considerably slower and continuing to this day), owes *at least* a small debt to FFIs, which successfully helped policymakers in Beijing to leverage international capital and expertise to centralize and maintain control over capital and banking domestically.

Chapter 3 shows that FFIs continue to raise grievances with respect to 1) China’s capital controls regime, and 2) the inadequate sophistication of China’s domestic banking and financial markets (which includes inadequate expertise of financial and banking sector regulators), and 3) cost-of business related issues (which include bureaucratic limits to local incorporation, branch expansion, and introducing new financial products). This should be contrasted with a lack of explicit institutional and legal discriminatory measures that continues to define foreign involvement in Chinese banking, equities, and PE industries.<sup>4</sup>

With respect to the second grievance noted above, this should not be taken to denote that a transfer of technical and managerial expertise along the Anglo-American model of finance has not taken place. Instead, chapter 5 will demonstrate that it has—but that it has been sufficiently tempered and modified by a process of localization of global financial practices as outlined by

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<sup>4</sup> Insurance was left out of the analysis in chapter 3 due to its inconsistent inclusion (and, at times, its outright absence) in the European and American Chambers of Commerce annual reports’ financial services section (as well as some inconsistency in issue areas, which complicates the coding of FFIs’ grievances). However, it should be noted that PwC’s annual *Foreign Insurance Companies in China* points to broadly similar concerns to those expressed in its Annual *Foreign Banks in China* surveys, which were included in this analysis. Moreover, the short section on foreign insurers in chapter 5 illustrates that they operate in a broadly similar environment to that of foreign investment banks, commercial banks, and PE companies.

Robertson (2015), who draws from the framework originally posited by Rosenau (1997), which stresses the compatibility between globalization and localization. As noted above, one of the arguments made in this thesis is that FFIs have played an important role in transferring Anglo-American financial expertise to China's regulatory agencies and banking system. This argument is not uncontroversial in the literature on the political economy of China's financial system. For example, Knaack (2015) and Kempthorne (2015) argue that Chinese banks and regulators have gone out of their way to comply with international financial standards. By contrast Andrew Walter (2008) and Carl Walter (2011) have made the case that China's compliance with global financial standards has been largely superficial. My own argument does not necessarily support either side of the debate. Instead, as chapter 3 explains, I find support for both opposing sides. I show that, with respect to trade in financial services, the Chinese state can implement formal, legal liberalization, while maintaining perfectly legitimate barriers to foreign capital, including: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets. To paraphrase Palan (1998) China has been able to "have its cake and eat it too:" playing by the rules of the game still leaves China with enough levers to limit the influence of foreign capital within its borders.

Palan (1998) has analyzed the ways in which states use offshore financial centers and tax havens to enjoy the benefits of borderless capital flows while maintaining regulatory barriers and, generally, enjoying the perks of state sovereignty, at home. China has been able to do something similar, as Chapter 4 shows, especially by resuming sovereignty over Hong Kong, but implementing a "one country, two systems" governance structure over the city. It was able to use the capital markets in Hong Kong to foster financial experimentation that eventually allowed its SOEs to raise capital there and, eventually, in New York, which prompted these SOEs to become more efficient. Chinese policymakers were able to accomplish this without having to sacrifice the privileged position of SOEs at home and without inviting foreign capital to play a greater role in

its closed, domestic financial system. FFIs have been crucial to constructing this system, as they helped to restructure Chinese SOEs (or, in the case of early restructurings, to structure them from the ground up) to prepare them for overseas listings. They were also decisive in helping to attract globally situated fund managers to purchase the shares of these companies. In doing so, FFIs effectively precluded the need for more private capital in the Mainland financial system.

To illustrate this phenomenon further, I show that FFI-state bank relationships since the early 2000s have been marked by an exchange of expertise for a *chance* to earn greater market share, especially in retail banking—an arrangement that has largely failed to bear fruit. Similarly, the inability of FFIs to either maintain their predominant market share in the private equity (PE) industry in China, or to convince the central government to lift the 25 percent cap on foreign ownership demonstrates their lack of leverage vis-à-vis Chinese policymakers. As described in chapter 3, this is partly due to FFI’s role in SOE and state-owned bank reform, as well as political resistance to foreign ownership that definitively reared its head after 2005. However, another piece of irony in FFI’s role in the evolution of China’s financial system is that the way in which they participated in this evolution, by relying on FFI-trained Chinese returnees, has also precluded the need for China’s banks and policymakers to rely on them as institutions. Parallel to Robertson (2015), my research also shows that the FFIs’ role—which was complementary to, but does not overshadow the policy of China’s government to incentivize overseas Chinese students to return to the Mainland (Zweig 2006; Zhang et al 2011)—of bringing returnees to the Mainland to make better connection with policymakers<sup>5</sup> has ultimately helped Chinese regulators and financial institutions acquire staff and expertise without directly relying on FFIs.

Since the tail-end of 1998, FFIs have proved themselves useful to China’s policymakers and despite a number of setbacks experienced in recent years, appear to continue to play this role

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<sup>5</sup> Robertson is more specific about the types of connections, emphasizing returnee-princeling linkages, while my own research suggests that direct returnee-government contacts were also important, particularly in some of the early global listings of Chinese SOEs.

in China's financial evolution: linking China's financial institutions and capital markets with the global financial system; providing financial institution restructuring with global legitimation, as well as foreign capital. While the country does not face a shortage of capital, as it did in the late 1990s and early 2000s, it does continue to face a persistent problem of capital misallocation (World Bank and DRC 2012), which allows FFIs to continue to be useful to Chinese reformers. As one FFI manager has noted, FFIs' small market role in the overall financial system in China belies their more important historical role in helping the system to perform a number of important functions absent the presence of FFIs (Interview with FFI manager 16 May 2013). We can see one such function playing out in the case of the recent Cinda listing in Hong Kong (Noble 2013), as well as the pending Huarong listing, which was recently approved for a \$3 billion IPO from Hong Kong securities regulators (Lee 2015), where restructured financial institutions look not to politicized and uncertain domestic stock markets (Li 2013) but to international markets—especially those in Hong Kong—in their pursuit of getting a market-based valuation for their business operations. This appears to be FFI's most lasting impact on China's financial evolution since the early 1990s. As the need for Western—specifically, Anglo-American—financial expertise declines (Robertson 2015) and as, with the passage of China's WTO accession, much of the important achievements in FFI home government-based lobbying are now a thing of the past, the last avenue for FFIs to play in China's future financial evolution remains continuing to help create linkages between the Mainland financial system, and global financial markets in Hong Kong, New York, and elsewhere.

#### **4.0 The independent variable**

Prior to moving forward with the empirical portion of the thesis, some clarifications must be made about the independent variable—foreign financial institutions—in the present analysis.



The term ‘FFIs’ refers to global financial institutions that are foreign to *Mainland China*<sup>6</sup> and have operations in more than one country). Local Hong Kong brokerages, for example, while foreign to China during the time period in which their role in internationalizing China is investigated (the early 1990s), are not included in the independent variable. Their role in internationalizing China’s financial system is, therefore, treated as related to but separate from global FFIs.

At times, it may appear that ‘FFIs’ refers more to American financial institutions than FFIs from elsewhere in the world. Indeed, Goldman Sachs, in particular, played the key role in the evolution of China’s financial markets, given its pivotal listing of China Telecom on Hong Kong and New York in 1997. However, banks from Hong Kong, Europe and East Asia also played important roles in the evolution of the Chinese financial system in various ways.

European and American firms carried out lobbying for the external liberalization of financial services in China in both different and overlapping capacities. For example, while much of the heavily lifting in pressing for the addition of financial services to the General Agreement on Trade in Services (see next chapter) was done by European firms, American firms were more significant in helping to press for its implementation in China (via the US-China permanent trade relations debate). Lobbying for the lifting of restrictions on foreign participation was as much a pet project of HSBC, as it was of CITI—who, in turn, fought Societe Generale for the chance (ultimately unsuccessful) to be granted the first exception to these restrictions. It should also be noted that each of the Chambers of Commerce position papers surveyed in chapter 2 includes the voices from financial institutions from across the globe. As it turns out, the ‘American’ or ‘European’ identity of these interest groups is a fluid one.

Similarly, while Goldman Sachs, Morgan Stanley, and other American investment banks might have taken the SOE foreign listings experiment globally in the late 1990s and early 2000s,

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<sup>6</sup> Hong-Kong based banks are also included in this category because two of them, Standard Chartered and HSBC, are technically UK banks and because Hong Kong is a globalized Chinese city. Chapter 4 will elaborate on this point in great detail.

the experimentation that informed these successes was carried out by smaller financial brokerages in Hong Kong in the early 1990s and taken to a larger scale by Hong Kong Banks such as HSBC. In the area of transferring expertise, it was a global, commercial banking arm of the World Bank, the International Finance Corporation (IFC) that first pioneered the enterprise transfer model in the early 1990s that would be taken up by American and European banks on a national scale in the 2000s (see chapter 5).

Therefore, the independent variable in my analysis is a relatively abstract one. Not only does it include a range of different financial institutions (commercial banks, investment banks, private equity firms, and insurers) it also precludes strict national origin classifications. These different actors have been lumped together for analytical purposes because their interaction with Chinese policymakers and financial markets brings clarity on both theoretical and empirical grounds. Theoretically, their common narrative gives us a clearer picture of the distinction between internationalization and liberalization and helps us to illustrate the power of multinational enterprises. For example, private equity firms and investment banks both internationalized China's financial system, albeit through different international linkages. Similarly, private equity firms and commercial banks ran up against the same wall (albeit in different stages and cycles) when competing with their domestic counterparts. Empirically, foreign actors in each sub-industry of the financial system illustrate the same narrative: that of foreign actors leading Chinese financial institutions to adopt foreign practices; and persuading Chinese policymakers open their markets to foreign participation and raise money overseas without quickly dismantling the country's capital controls. And, in an ironic twist of fate, it is these changes that created obstacles toward their greater participation in China's domestic financial system.

## 5.0 Conclusion

This thesis seeks to answer the following question: What role have FFIs played in China's financial evolution since the early 1990s into the system that defines its financial landscape today? My research finds that FFIs have played a pivotal role in three aspects of China's financial evolution. First, US financial institutions have leveraged their influence in the US government and their ties to other business groups and to Chinese elites to help China to join the World Trade Organization in 2001, thereby creating a relatively open *formal*, legal environment to foreign actors—helping in the cause of liberalizing China's financial system. Second, and much more significantly, FFIs have aided in Zhu Rongji's push to reform the Chinese banking system and state-owned enterprises in general by creating linkages between the Chinese state and global finance and, in the process, helping to create a vast market of overseas Chinese equities in Hong Kong, New York, and elsewhere. Not incidentally, FFI's efforts also helped to establish Hong Kong as a Chinese offshore financial centre, and a specialized and highly internationalized global city. Thirdly, and also very consequentially, in relying to 'returnees'—Chinese professionals returning to work in the Mainland after studying finance in Anglo-American institutions and, working in finance on Wall Street, London, and Hong Kong—to secure deals with Chinese officials FFIs have helped to transfer Anglo-American financial expertise to the Mainland. While the localization of Anglo-American financial expertise has stopped far short of a full acquiescence in foreign knowledge and practices, the ways in which this knowledge has become adopted and changed to suit China's political economy also stems from the way that it was transferred to China by FFIs—a process I defined as internationalization. By helping Chinese policymakers to use Anglo-American financial expertise to internationalize corporate finance, banking, and private equity, not to mention insurance, investment banking, and a host of other sub-industries, and to fund Chinese state-owned enterprises (SOEs) and state banks in their time of need (in the late 1990s and early 2000s)—and to do so while maintaining state ownership over these enterprises—FFIs have, ironically, precluded the need for policymakers to give them a greater role in China's domestic

financial system. In other words, FFIs have come to face the obsolescing bargaining dilemma that Vernon (1971) first proposed with respect to multinational oil companies.

As the next chapter will explain, these linkages have explanatory utility in four sets of literature in international political economy (IPE) and China studies. First, it helps us to see the literature on the nature of Chinese capitalism in the reform era: it shows how FFIs have helped Chinese ‘state capitalism’ emerge by helping Chinese policymakers use the global financial system to strengthen Chinese financial and non-financial state enterprises. It also contributes to the literature on FFI lobbying for financial sector opening in both the Chinese and global context, by showing how FFIs impact policy changes by leveraging their connections to policymakers in more than one national context. The two linkages also help us to better situate the literature on the role of non-state actors in transferring and localizing global practices, especially in the case of post-communist transition economies by illustrating China’s unique experience with FFIs in this regard. Lastly, my research challenges the literature on the policy tradeoffs that emerging economies face in the post-Bretton Woods era of financial globalization. I will demonstrate the ways in which China has been able to use globally interconnected spaces like Hong Kong and New York to benefit from international financial integration without breaking down the national barriers to global capital.

## **Chapter 1: The Contributions of the Research on Foreign Financial Institutions to China Studies and International Political Economy Literature**

### **1.0. Introduction**

This Chapter outlines the theoretical contributions of this thesis. It aims to frame the subsequent four chapters as a study of internationalization and to outline some important limitations and specifications about the way that the main argument, narrative, and theoretical framing will proceed. It sets out to define the very specific ways in which the term internationalization will be used and how it contributes the existing IPE and China studies literature on China's reform and opening and its engagement with the global economy.

The chapter begins with a slight departure from the focus of this thesis: section 2 infers China's policy preferences on financial reform since the early 1990s from the existing literature thereon. The goal is to situate the agency of FFIs in China's financial evolution in the context within which the policy changes are made. Section 3 looks closer at the issue of liberalization, and problematizes it, with the goal of setting important distinctions between this phenomenon and the related but distinct phenomenon of internationalization, which is discussed in the next two sections.

Section 4 looks closer at the first of these two theoretical contributions of my research to the existing literature. It outlines my theoretical framework of internationalization, and explains how I construct this framework by drawing on the definition of internationalization from Keohane and Milner (1996), Zweig (2002), Schlichting (2008), and Chin (2007). It borrows from both global and China-based insights on the role of space in the process of globalization in Palan (1998), Lai (2012), and Sassen (2011), and the role of local-global elite interactions in Robertson (2015). It does not seek to challenge either author's insights, but rather to add to their research by looking at

the ways two international linkages theorized here—elite-based and spatial linkages—helps us to better understand FFIs role in China’s financial evolution and the role this plays in China’s financial internationalization in the reform period. Section 5 looks closer at the relationship between FFIs and the CCP as an illustration of the limitations on the power of non-state private actors and the host governments that seek out their capital and expertise. Drawing on Vernon’s (1971) notion of obsolescing bargaining, it suggests that FFIs have, in effect, created their own limits to playing a greater market role in China’s financial sector. The chapter concludes with section 6, which clarifies the breath and limitations of the present analysis and suggests counterfactuals to better situate the narrative offered in the introduction in the theoretical discussion of this chapter.

## **2.0 China’s policy preferences: what does the literature say?**

My research frequently refers to China’s financial reforms and the evolution of China’s financial system more broadly. Therefore, in discussing the role of FFIs in this regard, we need to have a working idea of something that is beyond the scope of my research: the preferences and goals of China’s policymakers toward financial reform across time. Clarifying this point helps us to better understand FFIs’ role in China’s financial evolution. However, this clarification is difficult because the existing literature on financial reform in China presents very different perspectives on the goals of China’s financial policymakers.

Much of the literature surveyed here suggests, implicitly (e.g., with respect to financial reform, Shih 2008) or explicitly (e.g. Naughton 2008; Walter and Howie 2012) that the degree and character of China’s global economic integration is the dependent variable in China’s reform process. In other words, China’s policymakers adopt a perspective of either economic liberalism (Steinfeld 2010; Brandt and Rawski 2008; Lardy 2014) or state capitalism (Bremmer 2010; McGreggor 2012; Huang 2008; Hsueh 2016)—or the related argument of rent-seeking/special

interest retrenchment (Shih 2008; Pei 2009)—and this policy framework defines China’s role in the global economy. The problem with many of these assertions, however, is that they are not easy to justify and substantiate on a longer timeline, across the broader span of the reform era in China from the late 1970s onward. Huang (2008), for example, is quite explicit about this, arguing that China was ‘reformist’ (i.e. market oriented) in the 1980s, but started to move in the direction of state-capitalism from the mid-1990s onward.

Walter and Howie (2012) also quite explicitly state that since 2005 financial reform was hijacked by SOE-connected special interests and the reform trajectory went the way of state-capitalism since then—and especially since the Ministry of Finance won important political battles against the People’s Bank of China in reforming the banking system and financial markets in the early and mid-2000s. Lardy (2014)’s argument that reform ultimately trends in favour of markets might stand up across time (Steinfeld 2010 adds a political dimension to this reform trajectory), but it is not a particularly useful framework for understanding individual sectors. Most pertinently, the discussion of financial markets and banking system reforms switches from a discussion of privatization to a discussion of intra-industry concentration, admitting that, for example, the overall rate of privatization in the banking industry has been low and insignificant compared to other sectors.

Moreover, the rhetoric of China’s leaders on financial (and economic) reform is notoriously imprecise about the kind of change the CCP is pursuing. For example, it is curious that current President and CCP Chairman Xi Jinping’s officially sanctioned collection of essays and speeches (Xi 2014) make no mention of privatization or liberalization at all. Of course, recent media accounts of China’s reforms have jumped on Xi’s explicit rhetorical commitment “to let the market play a decisive role in allocating resources” (Xi 2014, chapter 19, para. 4)), which makes some notably broad references to “scientific macro control” (which could easily mean monetary policy) and “openness and orderly competition” (which could mean enhancing the role of the rule of law). However, Xi’s May 26, 2014 CPC Central Committee speech, where this remark is found, also

speaks of this decisive role being augmented by the government “better perform[ing] its functions” and balancing out the market’s decisive role with a coordinative role for the government “to promote sustained and sound social and economic development” (Xi 2014, chapter 19, para. 3) In short, conducting a rhetorical analysis of Central leadership is typically difficult, if not impossible. Shambaugh (2008) has famously written:

China-specific analyses err on the other extreme and attend to the enduring practices of financial repression and capital control. While they point to important clues in explaining the state’s reluctance to pursue liberalization, the transition from repression toward opening or the reversing tendency that brings the state’s retraction from its liberalizing commitment are rarely addressed. These different policy tendencies are studied in isolation, and have seldom been tied together as a continuum of possible financial opening outcomes. They also regard the central authorities and/or financial interests as key constituents, but have scantily incorporated subnational authorities, the local governments, that contribute to the policy process (p 10).

My research agenda does not aim at discounting or privileging one perspective over another. I do not have access to new policy documents or communications of national or subnational authorities in China. Moreover, as described in detail above, the lack of robust evidence of a concrete Chinese ‘policy’ guiding external financial liberalization (especially openness toward foreign actors)<sup>7</sup> makes it difficult to agree or disagree with either view. Instead, I propose scaling back judgments about

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<sup>7</sup> My own analysis, admittedly, offers no good way forward in theoretically conceptualizing and empirically justifying any such policy. Yeung (2008) has come closest to conceptualizing China’s approach to financial liberalizing by examining the concept of ‘economic security’ (and the related notion of financial security) used by policymakers and those close to the policymaking apparatus. As Yeung’s analysis makes clear, however, the idea of financial security is imprecise and does not have an official sanction or definition.



the trajectory of financial liberalization in China in favour of deferring to a theoretical baseline on China's financial liberalization. Rather than trying to hone on the logic of policy reform, I propose, as others have (see Gruin 2014), to drop the dichotomy between states and markets and acknowledge that global economic and financial integration does not preclude a large state presence in banking and financial markets. The next section explores this idea in greater detail, and the subsequent chapters lay out the notion of financial internationalization.

### *2.1 What do we know about China's policy preferences?*

China is a particularly difficult country to study. The plethora of perspectives examined above, which I have divided into the market economy and state capitalist perspectives, respectively, is a testament to the complexity and opacity of the policymaking process. Those emphasizing bureaucratic approaches to China's politics tend to give little agency to the role of subnational governments in driving China's economic reforms (Zweig 2002 offers a critique of bureaucratic approaches and emphasizes the important of local state actors) This is true of much of the state capitalism perspective, which tends to hone in on the CPC, and disregard sub-endogenous and exogenous factors driving reform. Those looking at international factors, and especially those in the market economy camp described above, tend to look at the increasing array of institutional and normative similarities between China's economy and the institutions and normative practices in the wider global economic and financial system. My purpose here is not to suggest which perspective is most accurate, and at the risk of being perceived as deliberately conciliatory, I suggest that neither view is incorrect. By putting the question of privatization aside we can, in fact, find a baseline from which to evaluate financial reform.

My research on the bifurcated process of financial reform in China does not suggest a predictive theoretical perspective about the policymaking apparatus in China. There is insufficient

evidence to propose a new perspective or to reinforce an existing perspective. Instead, it suggests, as others have begun to do (see, for example Gruin 2015b), that the global economy and global financial system is actually quite indifferent on questions of privatization and the proper role of the state. In other words, I suggest that China's experience with financial liberalization says more about the international financial system than it does about China. As such, I do not seek to give a satisfactory answer to whether China is entering a period of reform or retrenchment of the state in its financial sector. Rather, empirical evidence points to China's willingness and effort to join the global financial system, but suggests little about where reform is headed.

To start, I will clarify what I mean by 'China's integration with the international financial system.' As late as the end of 1998, the year Zhu Rongji became Premier and began to actively promote his "three implementations" of reform of state-owned enterprises (SOEs) and the financial system (Zhu 1998) China's presence in the global financial system was limited. While initial experiments with exposing China's agricultural and manufacturing sectors had exposed China to the global market place, practices and concepts like financial regulation, corporate governance, and transaction-based business (i.e. non-relationship, *guanxi*,-based business practices) were only beginning to be implemented (Zweig 2002). Indeed, just a year prior, then Goldman Sachs executive and later US Treasury Secretary Henry Paulson Jr. met with then head of China Construction Bank Wang Qishan and Zhu Rongji in the *zhongnanhai* (China's leadership compound) to discuss transforming China's telecommunications industry by listing shares of China Telecom in Hong Kong (Paulson 2014). The transformation of SOEs—and, importantly, their listing abroad—and China's and China's later successful bid to join the WTO became the foundation for China's importing of Western practices in financial services. I examine both the passive (in the case of commercial banks) and the active (in the case of investment banks) role that foreign financial institutions played in this transformation.

Zhu's successful round of reforms in the late 1990s and early 2000s—helped along by the Asian Financial Crisis (Wang 1999) - accelerated the importation of norms and practices in the

areas of banking and finance. As Wang (2007) has documented, discourse in the Chinese media, in academia, and in policy circles around the phrase “link up with the international track” (*yu guoji jiegui*; 与国际接轨) began to rise in the late 1990s and, despite opposition, in the area of politics, culture, and in the social sciences (Zweig 2006). In the area of natural sciences, economics, and finance, international norms have become the mainstay of government rhetoric.

Since joining the WTO, China’s interaction with the global financial system has gone much further than simply adopting English as the required language in banking—albeit, speaking the language of international bankers is not an unimportant transformation (Selmier 2015). In the area of commercial banking, and domestic financial standards more broadly, China has met and even exceeded international standards (Kempthorne 2015; Knaack 2015). In the area of corporate governance, China had chosen to rely, as closely as possible, on (Organization for Economic Cooperation and Development (OECD)-promoted principles and norms. As the OECD’s declaration on the these principles outlines, there are 6 broad corporate governance standards including: 1) a legal framework that “clearly articulate[s] the division of responsibilities among different supervisory, regulatory and enforcement authorities” vis-à-vis a public company; 2) the treatment of shareholders as legal owners of a public company; 3) the equal treatment of shareholders under law; 4) the recognition, under law, of the rights of non-shareholder stakeholders (like employees or others affected by a public company’s operations); 5) the disclosure of financial information to shareholders and (where applicable) to the public; 6) a legal and regulatory framework that enshrines a public company’s executive board’s responsibility to a the company’s shareholders. (Organization for Economic Cooperation and Development 2004, p. 17) According to a speech by PBoC Governor Zhou Xiaochuan (Zhou 2006), adopting OECD corporate governance principles has been an important pillar of SOE and (more broadly) economic reform in China since state council formally committed itself to adopting corporate governance principles at the Fourth Plenary Session of the 15th National Congress of the CCP.

Zhou argues that while the Company Law of 1994 did not immediately lead to adaptation of these standards due to the poor understanding thereof by policymakers and SOE managers, the 2000s saw a real effort and real progress in their implementation. Feinerman (2007) observes that, indeed, the amendments to the 1994 Company law (in 2005), as well as other legal changes since 1999, have demonstrated a real attempt by the CCP to implement OECD corporate government principles at a relatively fast pace, despite a plethora of outstanding issues left to resolve in this area.

In the area of central banking and monetary policy, China has fairly unceremoniously adopted international practices (Bell and Hui 2013; Steinfeld 2010); financial stability, a relatively new concept in China, has been developed and refined with active dialogue with international financial institutions (Zhou 2007). In the area of securitization and regulating new financial products, Chinese regulators are in active conversations with foreign bankers based in China on how to understand and implement appropriate regulatory practices.

A number of scholars have also noted the decline of the influence of informal ‘guanxi’ network and an increasing convergence toward international norms in business relations (Guthrie 1998, Judd 2007; Deng and Kennedy 2010). Even more clearly, China has moved from a footnote in the international financial system, to playing a key systemic role therein (Helleiner and Kirshner 2014). To be sure, Nolan (2010) disputes that international norms are necessarily taking route in the area of commercial and investment banking, arguing that the political economy of China’s financial system does not allow for a deep penetration of international norms and practices. Most significantly, she argues that contract-based, formalized transaction banking has not made significant inroads into the Chinese financial landscape. However, as Selmier (2013) notes, the dichotomy between ‘Western’ and ‘Chinese’ (and more broadly East Asian) banking norms is empirically unfounded, as Western and Chinese bankers practice a degree informal relationship-based and contract and legally based ‘transaction banking’. Rather, it is more accurate to see

corporate governance (at least in banking) as a *continuum* of relationship and transaction banking (See Selmier 2013b for a more detailed discussion).

This is not to suggest that China is a passive recipient of international norms and a ‘go-along’ member of the international financial system. As PBoC governor Zhou Xiaochuan (2006, p. 2) put it in a Bank of International Settlements (BIS) conference nearly a decade ago, describing China’s approach to corporate governance,

China wishes to learn from international experiences and practices in the process of building a socialist market economy with Chinese characteristics. It can be said from the point of view of a socialist market economy, China should do better in terms of employees’ status and their involvement in managing companies. However, we do not have any established principles or framework related to stakeholders. We will learn by doing and reviewing experiences.

This study will show how FFIs have helped China to ‘have its cake and eat it too:’ to access the capital and expertise of the international financial system without—or at least prior to—fully enacting domestic and external liberalization. As the existing literature makes it clear, China wants to ‘join’ the international financial system; and in many ways it has done and continues to do so, with the latest round of reform focused on liberalization of capital flows (Chang 2015). However, the processes by which China has joined the international financial system and the extent to which international norms, practices, and incentives have changed China are not readily apparent. In this respect, applying the bureaucratic politics framework without grounding the analysis in the social context in which it takes place would make China appear as a state capitalist economy. By contrast, looking at the profound change in China’s laws and government agencies, and the growing role of the non-state sector in China’s economy, makes it appear that China’s is, quite fundamentally,

‘playing our game’ (Steinfeld 2010) and converging closer with Anglo-American liberal market norms and practices of the global economy.

I suggest that much of the scholarship on the role of the state and the market in China’s economic transition misses the important distinction between internationalization and liberalization. The goal of the next section is to outline what is meant by internationalization of Chinese finance and to explain how the study of FFIs in China can help us to understand the interaction between the idiosyncrasies of the Chinese financial system and the constraints and opportunities offered by globalized finance; and, most importantly, the role of FFIs therein. While the present research does not seek to contribute directly to the debate surrounding the future of financial reform in China, it seeks to clarify how banking and financial markets became transformed by China’s greater integration with the global financial system and how the case of FFIs market entry helps us to better understand the extent of the linkages formed in the process of internationalization and the limitations to these linkages.

### *3.3 The Problem with ‘liberalization’*

The process of financial liberalization is defined as the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition. However, when economics and political science literature references external financial liberalization specifically, there is a lack of agreement and precision about the meaning of the term. This section addresses this issue, with the goal of clarifying what the term means in the context of the present analysis.

Because the process of financial liberalization is multifaceted and contested in the existing literature on the subject, it bears some teasing out. Financial liberalization can refer to domestic liberalization, namely the increasing reliance on market mechanisms to allocate capital. This refers to a number of policies that include, but are not limited to, interest rate liberalization, regulation of

financial instruments, and oversight over daily financial transactions. The ‘domestic’ variable in this equation suggests that policies and reforms under discussion would only concern the domestic economy, and would say little about the extent of a country’s integration with the global economy. The latter refers to external financial liberalization. This refers to laws and policies that govern a country’s integration with the global economy. This includes the flow of financial capital across borders (capital account liberalization, in the parlance of international financial institutions), openness to foreign financial institutions, and virtually any law affecting the movement of foreign banks and foreign money across borders.

One problem with examining external financial liberalization is the confusing role of capital account liberalization as an explanatory variable. In political economy terms, openness to foreign financial institutions is conceptually difficult to segregate from capital account liberalization. Capital is not only FFIs’ currency as international financial actors, but more importantly it is also their agency as non-state actors. In fact, capital account liberalization and international capital mobility change foreign financial actors’ relationship with governments, giving significant agency to financial actors vis-à-vis governments in some areas (Mosley 2000). As such, some might find it hard to imagine a country being ‘open’ to FFIs if said country also limits how much money they can bring in and out of the country. Martinez-Diaz (2009), for example, sees openness to foreign financial institutions as an important cornerstone, and more importantly one of the most politically contested issues of financial globalization. Under this theoretical framework, restrictions on foreign ownership and participation in emerging economies’ domestic banking and financial system is a way to limit the effects of capital account liberalization and maintain national leverage vis-à-vis global capital markets.

At the same time, openness to FFIs and capital account liberalization are not even necessarily in the same category of liberalization policies. Economists are not in agreement about openness to foreign financial institutions as an endogenous (domestic) liberalization variable. Hauner and Prati (2008, p. 11) put it alongside “(i) credit controls, such as directed credit; (ii)

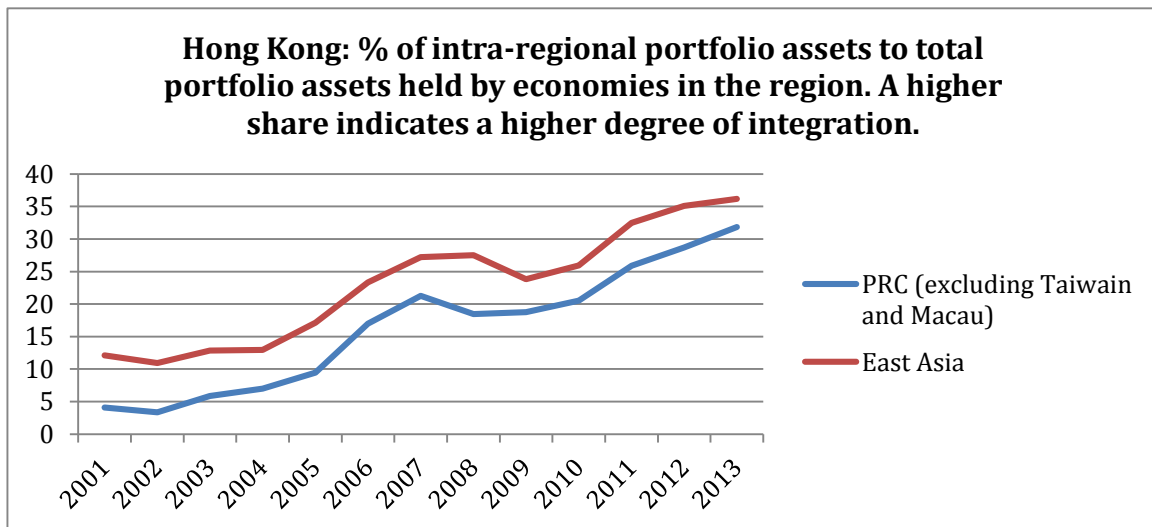
interest rate controls, such as floors or ceilings; [...] (iv) competition restrictions, such as limits on branches; (v) the degree of state ownership; and (vi) aggregate credit ceilings.” And while Abiad et al (2008) takes it even further and includes privatization in the banking sector into the mix of financial liberalization measures (avoiding endogenous-exogenous liberalization abstractions entirely and positing each measure as an independent variable on the dependent variable of ‘financial liberalization’), they too see it as distinct category of opening. However, other economists dispute this categorization of a country’s openness to foreign banks under the umbrella of domestic liberalization. Zhao (2006) focuses specifically on China and sees openness to foreign commercial banks in China’s Special Economic Zones (SEZ) (to say nothing of investment banks and other, non-bank financial firms) as a key variable in China’s external liberalization process. Under his analytical framework, liberalizing the capital account—the removal of legal barriers to foreign actors trading in Chinese financial assets, and the concomitant removal of barriers to Chinese citizens’ trading in foreign assets—is only one of many variables of external liberalization, which also includes foreign exchange controls and business and ownership restrictions on foreign banks.

To summarize, openness to foreign financial institutions constitutes elements of both domestic liberalization and financial openness. When coupled with the difficulty of separating capital account liberalization from openness to FFIs, this creates a conceptual minefield that is difficult to cross. Unfortunately, my own framework does not provide a way out of this theoretical dilemma—in fact, it further complicates it. In the area of investment banking, the presence of Hong Kong as bridge between China and the global financial presents us with two different Chinas: one where the capital account is fully liberalized, and where foreign banking restrictions are exceedingly low, even by developed country standards (ICC 2013), and where the distinction between foreign and ‘domestic’ banks is blurred by favourable regulations. The other China—mainland banking and A-share equity markets in Shanghai and Shenzhen—is one that remains the domain of domestic banks and other financial institutions.



In the case of Hong Kong, the picture is very clear: the city’s financial sector is liberalized across virtually every indicator in Hauner and Prati (2008) and Abiad et al (2008); In general, the island is highly globally integrated not only in terms of commercial banking assets, ownership restrictions, and business/product licenses (ICC 2013) but in terms of financial markets integration. Figure 1 shows the percentage of portfolio assets held by public and private actors in East Asia and Mainland China over a 13-year period starting in 2001, when China joined the WTO. With most assets held by non-Hong Kong residents and with a large minority of portfolio assets held by Mainland China, the island is financially integrated not only with the PRC but with its regional neighbors as well. China’s integration into the global financial system is, by contrast, relatively low. While the range of indicators used to measure integration is different from those used to evaluate Hong Kong (due to lack of reliable data), a number of studies show that across the economy is still sealed off from the global economy in terms of banking and financial assets (Bank of Canada 2008; Deutsche Bank Research 2011; Chang and Lochel 2012). Figure 2, for example, show’s China’s overseas portfolio assets compared to the UK, US, and Japan; on this measure it is among the least globally integrated Asian economies in terms of finance.

**Figure 2**



*Data from: ADB 2015*

Because China is relatively well integrated with Hong Kong in terms of financial assets, and in terms of Chinese financial institutions operating subsidiaries in Hong Kong (chapter 4 explores this in more detail), including or separating openness to foreign financial institutions from China's control measures doesn't provide a very useful description of financial liberalization in the PRC. Moreover, quantitative measures of integration are unlikely to sufficiently explain how China has used Hong Kong to access global financial markets, while only very gradually opening its domestic banking and financial markets thereto.<sup>8</sup> As such, this thesis acknowledges that the definition of external liberalization is not exact. Roughly put, external liberalization is taken to mean the degree of access given to foreign financial actors—full stop. It may or may not include capital controls, if such restrictions impede foreign actors' business to a significant degree. Therefore, we might say that in the area of commercial banking, external liberalization has been quite limited, while in the area of equity markets it has been quite extensive. This also underscores the importance of foreign financial institutions not only as actors, but also as variables that describe one aspect of China's financial openness.

### **3.0 Distinguishing Internationalization from Liberalization**

This section will outline my contributions to existing IPE and China studies literature by positing a distinction and relationship between liberalization and internationalization, which is not well understood in the literature on post-socialist transition and on the liberal international order.

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<sup>8</sup> Because China has a three-tiered equity market (A-shares, B-shares, and foreign H-, N, etc, shares) the data normally used to illustrate financial integration in emerging and advanced economies does not capture China's idiosyncratic equity market setup.

The first two subsections explain two sets of literature that this theoretical contribution concerns: The China studies debate on the nature and future of Chinese economic reforms and the IPE debate on globalization and the role of the state. It offers a definition of internationalization as a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as global cities or production chains. It describes how both sets of literature can benefit from applying this definition to China's financial internationalization between 1990 and 2012, which shows us that integration with the global economy does not necessarily imply liberalization: the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition.

### *3.1 China's economic reforms: the big debate*

My research was prompted in part by an ongoing debate about the future of financial reform—and more broadly, about the future of economic reform—in China. Throughout the 1990s, scholars of Chinese politics vigorously debated whether China would disintegrate under the weight of corruption, or whether market reforms would allow the country to escape the inefficiency of a centrally-planned economy, while keeping the country together. One side of the debate emphasized China's 'trapped' transition on the road to market liberalization (For contemporary iteration of this perspective, see Pei 2009; Åslund 2012). According to this view, China's selective opening and bureaucratic decentralization—the foundation of Deng Xiaoping and Zhu Rongji's strategy for legitimizing and diffusing market reform throughout the country—would inevitably lead to a crisis of governance and distorted market reforms would lead to economic stagnation.

A different perspective emphasized the transformative nature of China's institutional changes in the reform era. Those who saw China's economic transition in a more positive light

stressed the responsiveness and adaptively of China's political institutions to external pressures and internal crises (Yang 2004; Naughton and Yang 2004). This literature sometimes references the adoptive capacity of China's 'Leninist' political institutions and portrayed China's authoritarianism as malleable and adaptive in the face of demands for institutional change (Heilmann 2005b). However, following China's accession to the WTO and its increasingly prominent role in the global economy, the debate surrounding the future of China's economy took a different turn. As the CCP appeared to be more resilient than many had anticipated, and as economic openness became increasingly moot, debates increasingly centered on financial system reform and privatization.

While some saw China's financial and banking and financial markets becoming 'liberalized' and becoming more driven by market incentives (Green and Liu 2005; Chang and Loche 2012; Steinfeld 2010), others saw command economy legacies in China's financial system take precedence of market-based resource allocation (Shih 2008; Walter and Howie 2009, 2012). Those who take the former perspective stress the state's shrinking share in China's economy (Lardy 2014) and the resilience of China's central bureaucracy in the face of changing domestic economic institutions (Heilmann and Perry 2011). Those who take the latter perspective have tended to emphasize the role of intra-party bureaucratic politics in subverting the reform process (Shih 2007) or the role of the central government in using reform to finance state liabilities rather than enacting market reform to foster a rational distribution of financial resources into the economy (Walter and Howie 2012).

This recent debate harkens back to the prior debate in one fundamental way. One side sees China as changing to resemble other advanced economies, and the other sees China as failing to escape the inefficiencies of a command economy. And while these debates have certainly furthered our understanding of China's economic and political transformation since the 1990s, they are ultimately unsatisfactory. The literature that emphasizes China's eminent stagnation and stalled market reform tends to portray China's economic system as being state-capitalist (as opposed to 'market capitalist.') However, the idea of 'state capitalism' isn't very well defined. For example,

while many industries—including banking, telecommunication and energy—are dominated by state-owned enterprises, in a range of other industries, including manufacturing (Gallagher 2011; Huang 2003) and accounting (Gillis 2014) the state had outsourced the entire market to foreign-based multinational corporations. At the same time, those who emphasize a market-based trajectory fail to explain more recent trends towards re-nationalization in a range of industries including accounting (Gillis 2014) and private equity (Robertson 2015). Moreover, many of the newly emerging private technology and financial services firms have deeply institutionalized linkages with the Communist Party and enjoy significant advantages over foreign counterparts in accessing capital in China. This debate has also been picked up by IR scholars, who focus on whether China is, or will, join the existing international order, or overturn it to create something new (see Bremmer 2010; Ikenberry 2012; Hurrell 2007). The present research concerns China's financial liberalization since the early 1990s and will specifically explore the role of FFIs therein. The research presented here seeks to make a small contribution to the debate outlined above, by outlining the ways in which China's 'outsourcing' of financial sector development to international companies (Steinfeld 2010)—a process I will outline in detail and describe as the formation of spatial and elite-based linkages—makes China's financial system appear both 'state-capitalist' and market-oriented, and how the structure of the international financial system allows for this paradoxical outcome. Throughout this thesis I will show how FFIs have helped Chinese 'state capitalism' emerge by helping Chinese policymakers use the global financial system, and Anglo-American market liberal practices more broadly, to strengthen Chinese financial and non-financial state enterprises.

### *3.2. Financial Globalization and the State*

Lastly, my analysis has some implications for the debate about the role of the state and non-state actors in the study of IPE. The debate surrounding the role of the state in the post-Bretton

Woods era of international economic and financial integration (Strange 1996; Krasner 1999; Schmidt 2009) is not a new one and my intention is not rehash or further it. However, my analysis does lend support for the side of the debate that emphasizes the state's agency, specifically, vis-à-vis the global financial market. In a way, China's interaction with FFIs points to the inherent flexibility of the global financial system, which has allowed China to play by the rules of the system, while maintaining a great degree of agency in pursuing its own reform objectives. Specifically, my conclusions run contrary to a number of studies that examine the pressures placed on emerging economies by the international system to liberalize their financial sector to FFIs (Stein 2010; Martinez-Diaz 2009; Epstein 2008, 2014; Bonin et al 2010; McDermott 2007). In one way or another, these studies show that FFIs come to own a significant share of emerging economies' financial assets because the latter seek to take advantage of the benefits of global economic integration and cannot do so without ceding a significant share of national ownership.

I show that China is an important exception to the narrative that we have seen to take place in other emerging and post-communist economies. The policies pursued by China's policymakers allowed them to take advantage of the financing available on international stock exchanges as well as the managerial and financial products expertise offered by FFIs, while delaying the opening of its banking system to foreign ownership or the greater financialization of its economy. In this thesis, financialization is used to refer to the increasing reliance on non-bank financial instruments in the financial system—the disintermediation of debt (Epstein 2005). Alternatively put, it implies the rise of direct financing (Seabrooke 2001).

To be sure, the Chinese case might be more of an exemption than the rule—its economy is uniquely large and attractive for FFIs and investors across the globe. But it remains the case that for a country that has faced a domestic banking crisis (in the late 1990s), sought the aid of international capital, and sought out international legitimation and acceptance of its policies on foreign trade and investment, the benefits of global financial integration were leveraged without taking the same kinds of immediate trade-offs that many of its post-command economy transition

countries have had to take. Moreover, this outcome was no mere accident. Rather than conceding to this ‘defeat,’ FFIs have been instrumental in helping China to achieve these ends.

A common thread that runs through these two sets of literature is the dichotomy between states and markets. Regardless of the country case in question (China or other emerging or post-communist transition economies), there is always an implicit assumption that a tug of war persists between liberalization and state control. My goal in this thesis is to explain why the process of internationalization—a process through which China has engaged with the global economy—might blur this dichotomy. It is also to explain internationalization as a process that allows China to ‘have its cake and eat it too:’ to benefit from global markets and practices without necessarily scaling back the role of the state in allocating economic resources.

### *3.4 Defining Internationalization*

This section will outline my main theoretical contributions to the study of financial reform in China. It will explain FFI’s role in China’s financial evolution from the more abstract angle of China’s interaction with the global financial system. The study of the internationalization of the financial sector in China is not a new one. There is already a burgeoning literature on China’s power and leverage in the international monetary and financial system (Chin and Helleiner 2008; Helleiner and Kirshner 2014; Helleiner and Malkin 2012). However, these studies are concerned with the implication of China’s greater role in international finance rather than the process of internationalization itself.

The most detailed and systematic examination of China’s internationalization in the area of finance is Schlichting’s (2008) work on foreign banks’ entry into China’s banking and equities markets. Schlichting’s analysis offers a useful framework for understanding internationalization of China’s Mainland banking industry and stock markets. As Schilchting (2008, p. 2) put it,

Internationalisation here is understood as a process in which new (external) actors enter markets and in which the incentives and market environment of domestic actors are altered simultaneously. Internationalisation affects both market conduct and the rule-setting for markets, and through both contributes to market development. Altered incentives and constraints, new actors and actors' constellations, and new modes of interaction between regulators and industry players in the domestic market are key elements of this process.

Schlichting's study of foreign banks in China and her definition of internationalization represent the first scholarly attempt in the field of IPE to conceptualize internationalization of the financial sector in China; it is also the first systematic study of FFIs in China. However, the study is limited in a number of ways. First, Schlichting's study does not make a clear distinction between the process of internationalization in banking and financial markets. Because her focus is on finance in the Mainland it only includes a cursory discussion of international IPOs of Chinese firms and the role of the outsourcing of Chinese equity market development to overseas stock exchanges in the process of internationalization. Another limitation (flowing logically from the first) is that Schlichting dichotomizes the process of globalization as choice between exogenous norms and practices and endogenous prerogatives.

Schlichting is not alone in drawing these conclusions. Nolan (2010) for example, has surveyed the opinion of foreign banks with respect to the norms and practices of international finance as they are realized in China. She finds very limited normative diffusion at the bureaucratic and corporate governance levels: "While regulators may still aim for international standardization, the experience of the participants in this study is that, at the level of the organization, there is little will, and few incentives, to change current practices" (Nolan 2010, p 431). This suggests an inside-out causal mechanism, whereby Chinese policymakers, bureaucrats, and financial institution



managers only adopt those aspects of international finance that fits their organizational and normative worldview. Gonzalez-Vincente goes even further and concludes that

Whereas it could be argued that China's gradual integration in the international political economy has occurred via the acceptance of certain hegemonic patterns of capitalist socio-economic organization, there is little evidence of the extent to which this may have been the effect of Western economic and cultural dominance rather than of inner Chinese governmental and extra-governmental strategies contingent to China's 'Opening Up' and 'Going Out' processes (Gonzalez-Vincente 2011, p. 404)

However, these studies fall short of clearly tracing the degree and processes of internationalization; namely, how international financial practices were adopted (what policies led to their adaptation) and in what ways they were fundamentally rejected.

Robertson (2012; 2015) has, by contrast, conducted a detailed study of private equity (PE) in China by examining the impact of 'returnees'—national elites educated in overseas universities and bearing international experience in the field—on the industry. With reference to Steinberg's (2001)'s notion of 'bilateral activists,' who have one foot in the world of global elites, and one foot in the world of China's national *princelings* (descendants of China's Civil-War era CPC elites), Robertson describes how the influence of financial returnees both brought global practices to Chinese PE and endogenized them. Unlike Nolan, Robertson finds a large degree of diffusion of international practices and norms in the area of PE, demonstrating that while unable to challenge the core structure of China's political economy (i.e. dominance of state firms and the preference for CPC-connected private firms), the business models and corporate governance of locally-owned Chinese PE firms very closely resemble international models. Chin (2007) has argued that the process of internationalization in China cannot be defined as strictly an 'inside-out' process, driven

by local choices and policy prerogatives, or an ‘outside-in’ dynamic, whereby exogenous norms and practices displace local ones. Chin contends that China’s experience has been somewhere in the middle on a scale between inside-out and out-side in, with exogenous norms and practices influencing China’s policy prerogative, just as China’s policymakers modify these norms and practices, choose the ones they deem appropriate for China’s conditions and level of development, while rejecting others outright.

With respect to the first limitation in Schlichting’s study, there is, in fact, a dearth of literature to explain the difference between the fully internationalized Hong Kong and the very partially globalized Shanghai/Shenzhen financial markets, let alone the significance of overseas Chinese listings in New York and other global financial centers. The only exception is Walter and Howie’s (2012, chapter 6, para. 28) brief discussion of overseas IPOs and their apt observation that Zhu Rongji’s decision to let Chinese companies to begin listing overseas “led the dramatic growth of the Hong Kong Stock Exchange (HKSE) from its position as a small regional exchange in 1993 to a global giant in the twenty first century.” But beyond this, the fact that academic studies barely mention the explosion of overseas listed Chinese assets (especially their proliferation since the 1997 China Telecom listing) as an aspect of China’s financial liberalization demonstrates a significant gap not only in China studies but in the study of IPE as well.

Lastly, Schlichting’s analysis is lacking in ways that are similar to past studies of the subject—in particular when the country in question is a post-communist transition economy. Keohane and Milner’s (1996) edited volume of case studies of internationalization relies on a very similar definition of the term, emphasizing the “underlying shifts in transaction costs that produce observable flows of goods, services, and capital” (p. 4). The key characteristic of their definition (and that of Schlichting’s) is the change in transaction costs and interests facilitated by exposure to international markets and institutions/practices. But neither Schlichting (2008) nor Keohane and Milner’s (1996) volume make a clear distinction between internationalization and liberalization. A

number of important questions remain, including: do the change in incentives and interests ultimately lead to liberalization? And, if so, what is the process by which liberalization occurs?

Empirically, Keohane and Milner's framework was not entirely on sound grounds because, as the chapters by Evangelista, Shirk, and Haggard and Maxfield (respectively) showed (See Keohane and Milner 1996), in the case of late-industrializing economies and large and powerful post-communist transition economies (Russia and China), integration with the global economy had little to do with exogenous pressure. Rather, it was driven entirely by domestic financial crises. Zweig (2002) attempted to resolve these empirical issues by describing how Chinese policymakers created localized spaces of experimentation where local policymakers' and private actors' incentives could be altered. Very usefully, Zweig discussed 'linkages' between China's domestic economy and the global economy (he identifies rural, industrial, and educational). Zweig, however, was imprecise about how the segmented and localized experiments he documented would be adopted nationally and whether, again, this would ultimately lead to liberalization: the retreat of the state from the economic sphere and its replacement by private actors. His work, however, did produce important insights about the functioning of Chinese policymaking and its interaction with the global economy: the idea that linkages with the global economy could be established without actually liberalizing the sectors to which the global economy becomes connected. This may seem paradoxical, but a number of more recent studies shed light on how internationalization could be understood as a process that is related to but ultimately distinct from liberalization.

Mary Gallagher (2011) and Huang Yasheng (2003; 2011) provide us with studies that question the idea that introducing foreign enterprises and foreign business norms and labour practices necessarily translates into the liberalization of a particular sector of the economy. Gallagher (2011) argues in *Contagious Capitalism* that foreign firms in China's manufacturing sector provided testing grounds for new labour and management practices for Chinese SOEs to directly emulate—to become efficient through learning and emulation rather than through direct competition. In this scheme, SOEs benefited at the expense of private firms. Huang (2003; 2008)

takes this argument further and suggests (with the aim of critiquing the CCP's approach to economic reform) that deliberate state discrimination against private domestic firms has allowed foreign firms to benefit from privatization, which was, in effect, a project of selling Chinese assets to foreigners rather than private domestic capitalists. In both instances, the CCP is motivated by wariness (if not hostility) toward private domestic interests. And in both instances, an implicit distinction is made between liberalization (the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition) and internationalization, as the introduction of foreign norms and practices (through FDI, in their respective cases).

Taking these insights into account, I offer the following definition of internationalization: a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as global cities or production chains. In this next section I explain that internationalization, in China's case, was carried out through the formation and expansion of elite-based and spatial linkages between China's financial sector and that of the global financial sector.

### *3.4.1 Elite Linkages*

Drawing on Zhang et al (2011), Liu (2012), Robertson (2015), and Wang (2012) (all of these represent an emerging new literature on the role of returnees in China's economic development) I emphasize the role of financial returnees and prominent FFI managers to connect the global financial system to China's financial system at the elite level—as opposed to the every-day level (Hobson and Seabrooke 2007). Elite linkages also include prominent FFI managers bridging the policy consensus between the Chinese leadership and the policymakers in powerful countries like the US. These kinds of linkages helped to foster formal, legal external liberalization of financial services in China. Chapter 2 shows how FFIs used their own elite linkages in the US, as well as their linkages with Chinese policymakers to help Zhu Rongji accomplish his goal of WTO

accession. Chapter 5 focuses more on elite linkages created by financial returnees—overseas-trained Mainland Chinese—that return to China to work in FFIs.

The linkages established between international financial elites and domestic elites is formed through foreign-trained members of the Chinese financial elite, which have a foot in both the international financial world and the Chinese political system, are shown to be important in explaining how FFIs have been able to convince Chinese policymakers of the usefulness of their services. This reflects Chin's (2007) framework of internationalization as a process that is not a way one stream but a process that not only sees internal dynamics and transaction costs and preferences change by exogenous processes, but one that also sees domestic agency over the pace, process, and outcome of greater integration with the global economy. Simply put, constraints, vulnerabilities, and incentives of globalization are defined by policymakers.

As per Robertson's (2015) observation (explored in more detail in chapter 5), it will be demonstrated that while returnees are agents of international norms and practices in finance, they become agents of the Chinese state when they return to the Mainland, effectively *re-nationalizing* global norms and practices. Understanding the contribution to China's financial evolution made by financial returnees is key to understanding why FFIs' important role in restructuring Chinese SOEs and banks, thereby internationalizing Chinese equities, is key to explaining the irony in this role; that by bringing elite talent that is able to connect China's financial system with global capital and to leverage international expertise to help develop China's financial sector, FFIs have ultimately precluded the need for policymakers to rely on foreign institutions themselves.

### 3.4.2 Spatial Linkages

Drawing on Lai (2012)'s conception of spatial differentiation between Shanghai as a commercial centre, Beijing as a political centre and Hong Kong as an offshore financial centre, Sassen (2011)'s notion of the global city and 'localizing the global,' and Palan's (1998)

conceptualization of offshore centers (which allow states to “have their cake and eat it too”) the second type of linkage illustrated in my research focuses largely on how FFIs helped China to enjoy the benefits offered by the liberalized global financial system without having to fully join it. Spatial linkages are explored largely in chapter 4, which details how FFIs and China’s policymakers used Hong Kong and New York—the latter being the most important—to raise capital for Chinese state enterprises and to put pressure on them to restructure. As per the description of globalization offered by Palan, Beijing was able to ‘have its cake and eat it too’ by accessing capital markets without carrying out more rapid capital account liberalization. As Palan (1998, p. 627) puts it,

The argument is that by this process of bifurcation of the sovereign space, the state system is dealing with the more mobile economic sectors by providing them with areas where government interference is less stringent. And since these more mobile elements are increasingly bracketed out of the state, the state can carry on discharging its traditional roles as if nothing had happened, thus helping to alleviate some of the tension between globalization and the state system)

In developing this framework, in chapter 4 I borrow Sassen’s (2011) description of how globalization manifests in select localities (global cities), which is demonstrated neatly by the way in which China opened its doors to FFIs, allowing China’s SOEs to list in these global cities. I describe how Zhu Rongji and the pro-reform coalition’s decision to list SOEs abroad without first privatizing them at home created global linkages without taking on wide-scale privatization or capital account liberalization that would otherwise be required to raise financing in the scale that was deemed necessary. I also describe how this process was conspicuously aided and abetted all along the way by key FFI allies like Goldman Sachs’ Henry Paulson, whose pursuit of Chinese corporate clients made this process possible.

## 4.0 The Power of Transnational Financial Actors and the State

This section outlines my contribution to the existing literature on the role of transnational actors vis-à-vis state actors in the global economy. It notes the significance of FFIs, as non-state actors, in transferring global Anglo-American expertise, and the limits of this transfer of expertise in the process of localization of global practices. It posits that, in China's case, the elite-based linkages explored above have placed FFIs in a position of having to endure the outcome of obsolescing bargaining.

### 4.1 *Why do FFIs matter?*

Why study the role of FFIs in China's process of financial reforms? In IPE, the observation that private actors have significant authority in the global economy vis-à-vis states, is not a new one (, Higgott, and Underhill 2004). But as noted above, most perspectives on China's financial and economic reforms focus on bureaucratic politics or bureaucratic and institutional reorganization. However, there is a burgeoning literature in both the field of IPE and China studies, respectively, on the role of non-state actors in lobbying for and facilitating institutional change in both China and at the global level. Although examining non-state actors in the context of decision-making in China might seem like a fruitless encounter—given the CCP's well-known hostility towards independent (i.e. non CCP-connected) private capitalists and non-state actors (see, for example, Gallagher 2011)—Mertha (2009) and Kennedy (2009) have shown that the number of legitimate political actors in the policymaking process is actually growing. Moreover, China's membership in the WTO in 2001 had indirectly brought foreign financial actors into the policymaking process.

Sell (2000), Woll (2006; 2012) and Woolcock (1998) have provided an important overview of the role of international bankers, as part of a broader effort by global service sector firms, to

solidify the GATS in the WTO agreement. Sell has shown how European firms cooperated with US and UK firms in the mid-1990s, eventually forming the Financial Leaders Group to align their interests and to more effectively address financial services trade issues across very diverse political systems (namely the European Commission, the US, and the UK). Acting through the US Coalition of Service Industries and the UK International Financial Services London association (formerly, the British invisibles), firms like Goldman Sachs, Meryl Lynch, Citicorp, AIG and Barclays “established command posts” near the WTO headquarters and aggressively pushed for financial services liberalization to be maximized in the GATS (Andrews 1997 cited in Woll 2007a, p. 23). Woolcock has also observed that “providers of financial services are finding ways of gaining access to many new markets, even without the benefits of a multilateral agreement guaranteeing rights. The GATS negotiations on financial services are therefore moving with the flow of policy developments in most countries” (1998, p. 36). Wesselius (2001; 2002), however, further showed that financial services groups were key to the services liberalization negotiations leading to the 2000 GATS agreement and that, furthermore, the key lobby group, the Financial Leaders Group, was dominated by US companies.

From these studies we can infer two important observations about the characteristics of US financial sector lobbying on the opening of China’s financial markets. First, FFIs were not only significant but took the lead in negotiating the financial services provisions of the GATS. Second, FFIs are keen to affect the trade policies of emerging economies and are quite aggressive about shifting the paradigm of market openness towards the Anglo-American paradigm. With respect to China, this is borne out by congressional testimonies, where industry representatives argued that WTO financial services provisions are a crucial bridge to realize opportunities for US firms to expand their business in the country (US. Congress 2002).<sup>9</sup> Elites in favour of financial

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<sup>9</sup> To be sure, financial firms made no direct appeal to US lawmakers—or, for that matter to the public—on the narrow issue of liberalizing China’s banking, insurance, and capital markets. Certainly, this industry was frequently discussed in congressional hearings and in official speeches, but it was seldom mentioned outside of the broader context of promoting trade in goods and services. Existing literature on financial sector



liberalization, for example, find important allies in foreign actors with influence in the governments with which they are negotiating international treaties, such as China's WTO access (Robertson 2015).

The present study seeks to act as a bridge between the IPE literature on transnational and non-state actors and the nascent China studies literature that has begun to examine the same in Chinese context. Kennedy (2009) has examined emerging trends in business lobbying in China. Kennedy has shown that despite the CCP's hegemony in advocacy and public affairs, there is, in fact, an emerging practice of lobbying and advocacy, including the proliferation of business associations and some nascent formalization of lobbying channels. Deng and Kennedy (2009) have extended this analysis to foreign businesses as well. Foreign businesses as they note, are in constant contact with local authorities and State Council-level departments. This builds on Pearson's (1992) earlier analysis of the channels created by foreign enterprises to navigate the bureaucratic and ideological maze of Chinese politics. The analysis of foreign actors in the long process of China's financial reform is important not only because pro-liberalization bureaucrats might build strategic alliances with foreign actors (Cox 1987), but also because China's transition to a 'regulatory state' (Pearson 2005) leads to greater interaction and formalization of relations with foreign actors. Moreover, because finance is a highly specialized and complex field, policymakers often rely on the industry itself in formulating appropriate regulatory regulations—in 'learning' about how to approach regulatory issues.<sup>10</sup> These issues are explored in detail in chapter 2, which looks at FFI lobbying in the US Congress and in China, leading up to China's WTO accession. It looks at how FFIs utilized cross-issue alliances, as well as their triangulated lobbying networks, involving

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lobbying suggests that, despite their 'wealth' relative to other lobby groups, bankers, insurers, and fund managers lack normative and moral arguments necessary to push a policy agenda alone (citations needed). Typically, they require strategic alliances (as will be detailed in the next section) with other interest groups to push a particular agenda. For example, in resisting the regulation of financial derivatives, the financial sector relies on alliances with agricultural groups and homeowners, who significantly benefit from the use and proliferation of financial innovation (Pagliari and Young 2014).

<sup>10</sup> In the case of finance, see Barth et al 2012; Underhill and Zhang 2008; for lobbying as 'socializing' more broadly see Esterling 2009.

themselves, as well as policymakers in Washington and Beijing, to push for China's membership in the WTO and, accordingly the external liberalization of trade in financial services.

#### *4.2 FFIs as non-state actors*

The last big strand of literature to which my research contributes concerns much more than China or FFIs, but the role of non-state actors in the global economy more broadly. Most pertinently, my research contributes to this literature in three areas. The first is the well-developed literature on way in which predominant ideas (or, perhaps, 'hegemonic' ideas in Gramscian terms) and practices of global financial management, expertise, and governance are adopted in emerging economies. In the area of finance, some scholars have explored how ideas embedded and promoted by international organizations spread to and are adapted by emerging and post-communist economies. (e.g. Chwieroth 2007a, 2007b, 2009; Herrera 2010). The earlier literature on 'epistemic communities' (e.g. Adler and Haas 1992) has shown how agents of particular kinds of expertise spread and embed their knowledge and practices across very different institutional landscapes. Acharya (2000, 2004), while not studying the field of global finance, has documented not only how particular ideas spread to emerging economies, but how these ideas are, then, localized by policymakers and other agents of change and governance. Robertson (2015) has recently applied this study of localization not only to global finance, but also specifically to the case of China. Robertson showed how the predominant Anglo-American practices in financial sub-sector of private equity have entered China's domestic financial system, and how they have been modified by local agents to better fit the country's political economy. My research in chapter 5 builds on Robertson's findings and his theoretical framework to show how China's financial evolution over the past three decades has also impacted this localization. Indeed, this chapter details how other groups of FFIs have successfully influenced the development of the Anglo-American model of

finance in China's financial system; but that this success came with important modifications to these practices and that despite their role in spreading and embedding Anglo-American financial expertise, local agents did not ultimately take a back seat to FFIs in the Mainland financial system. In this respect, FFIs played the role of epistemic agents, but were not able to use their vast access to global capital<sup>11</sup> as leverage in bargaining with Chinese policymakers.

### *4.3 Obsolescing Bargaining and FFIs in China*

Chapters 3 and 5 show that, despite the important role played by FFIs in lobbying for external liberalization of China's financial system—through helping to lobby for China's WTO accession—and in transferring Anglo-American expertise to Mainland Chinese financial institutions these actors have found themselves in an obsolescing bargaining conundrum. First coined by Raymond Vernon (1971), obsolescing bargaining refers to a process in which MNCs' leverage vis-à-vis host governments erodes as the former no longer has the same degree of need to access the capital and expertise<sup>12</sup> of the latter.

While much time and many subsequent case studies have elapsed since Vernon coined the term, some scholars still maintain that it has robust applicability to many cases of MNC-government bargaining we see today. Vivoda (2008), for example, argues that multinational oil companies still face this obstacle in their dealings with government today. Eden et al (2005) argue that the term is worth resurrecting, but offer a slightly different definition, and calling it 'political bargaining': "The existence of economic, political and institutional constraints suggests that actual bargaining power may be greater or less than potential power, depending on several factors: the resources controlled by one party and demanded by the other, the similarity of interests and relative

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<sup>11</sup> In the late 1990s and early 2000s China was actually short on capital.

<sup>12</sup> Expertise is an addendum of the present study. Vernon did not discuss expertise in his earlier work.

stakes attached to the negotiation, the constraints on each party, and the ability of either party to limit the behavior of the other party directly through economic or political coercion.”

In essence, political and institutional constraints matter, even when foreign businesses have money, expertise, and the backing of their home governments. My analysis extends these studies of the global petroleum industry to global finance. Chapter 3 shows how, despite gaining market access via the GATS section of China’s WTO accession agreement, FFIs are limited by 5 systemic obstacles that allow FFIs to operate in the Mainland but inhibit them from gaining significant market share there as a result. These include: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets.

Chapter 5 shows that the obsolescent bargain that befell FFI was a certain twist of ironic fate: by helping Chinese SOEs and state banks to raise capital overseas and to restructure along OECD corporate governance principles and by partnering with Chinese banks in JV and strategic investment arrangements, they effectively precluded the need, on the part of the host government, for their expertise and capital.

## **5.0 Clarifications and Limitations**

### *5.1 Limitations*

This research is limited in a number of important ways that, while they do not detract from the importance of the findings, should caution the reader about what *should not be inferred* from these findings. First, although this thesis has stressed the importance of the role of FFIs in China’s financial evolution, my intention here has not been to say that the story of the evolution of China’s

financial sector since the early 1990s can be sufficiently explained by looking at the intervention of FFIs alone. As mentioned above, the evidence presented in the next three chapters unfortunately tells us very little about the degree of FFIs' importance. My aims here are more modest: I simply wish to posit that FFIs played a role that has been neglected in both the IPE and China studies literature on China's financial sector since the early 1990s. In fact, my research shows that their agency was also defined by a number of other, equally important—if not more important—variables. These include international financial centers (which can be categorized as places as well as institutions), Chinese policymakers, American policymakers, financial 'returnees,' and Chinese financial and non-financial SOEs. Therefore, FFIs exercised their agency among a plurality of actors.

Secondly, FFIs' role in creating overseas markets for Chinese equities was exercised in concert with a number of other actors, whose role is not explored in my research. These include international accounting firms (Gillis 2014, for example, provides important contributions in this regard), international lawyers (Chen 2013 provides some important insights on their role), and regulators responsible for overseeing the equity markets in the international financial centers (their role will be explored in a rudimentary way in chapter 4). A more complete analysis of FFIs role with respect to the overseas listings of Chinese SOEs would have to account for the role of these agents. This, however, is beyond the scope of this thesis. Lastly, chapter 2, which explores FFI lobbying in China's WTO accession, is based largely on the aggregation of secondary sources. While it does not offer much novel empirical insight the chapter is meant to consolidate the existing literature on FFI lobbying in global context with the literature (as well as additional data points and media sources, where needed) on business lobbying in China. The goal here is, first of all, to demonstrate that these two existing sets of literature help us to understand the ways in which FFIs have lobbied for market access in China and, even more significantly, that existing research *conforms to my theoretical hypothesis on financial internationalization*, as described below.

## *5.2 Clarifications*

The primary goal of this study is to explore the role of FFIs in China's financial reforms over a twenty-year period: since the early 1990s until Xi Jinping's chairmanship of the CCP in 2012. The narrative begins with the start of FFIs' role in China's financial evolution: with the earliest listings of Chinese SOEs in Hong Kong and New York. It runs through a number of important milestones in FFIs' interaction with the reform of the Chinese financial system and with China's financial markets. These include the first large restructuring and internationally significant listing of a Chinese SOE (China Telecom/Mobile), implementation of the WTO accession articles of agreement (pertinently, the GATS section on financial services), and the end of the Hu Jintao-Wen Jiabao tenure. The purpose of this timeline is quite simple: prior to the 1990s, there were few interactions between FFIs and Chinese policymakers and Chinese financial markets. After Xi Jinping and Li Keqiang took up their posts as heads of the Politburo Standing Committee, few financial system reforms concerned the aforementioned role of FFIs. Moreover, Xi's ambitious domestic economic and political reform agenda has far-reaching implications for the role of foreign firms in China that cannot be unpacked until the dust of the anti-corruption campaign and other major reforms has settled.<sup>13</sup>

As noted above, FFIs' role in the evolution of China's financial system is interpreted to be threefold: 1) helping China to achieve some aspects of external financial liberalization through WTO accession; 2) creating linkages between China and the global financial system by helping to restructure Chinese financial and non-financial SOEs and, in the process, internationalizing a large portion of Chinese equities; and 3) helping to localize Anglo-American financial expertise in the Mainland.

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<sup>13</sup> To be sure, a small number of mentions of FFIs in the 1980s and in the Xi/Li tenure are mentioned in this thesis, but these mentions are aimed at illustrating the background and impact of the roughly 20-year period of reforms discussed here.

But to be even more specific, what ‘financial reforms’ does the present analysis refer to? The three interrelated roles played by FFIs do not necessarily concern every aspect of China’s financial system and therefore my research does not examine or establish, or claim to establish, FFIs’ role in all aspects of China’s financial reforms since the early 1990s. First, it does not focus on the evolution of China’s monetary or exchange rate policies, or the central government’s policies towards inflation, which are in many ways crucial to understanding the scope and logic of financial reform in China (Shih 2008). Second, my research does not focus on the evolution and proliferation of financial regulatory agencies, which are equally important to understanding how China’s financial system has come to take on the shape and form described above. Heilmann (2005b; 2008) has examined this in some detail and more recent contributions to this literature continue to be forthcoming (e.g. Bell and Feng 2014; Chin 2013). And while my study revolves around explaining some of the characteristics of China’s financial internationalization, it does not concern the politics and policy of China’s currency internationalization (e.g. Helleiner and Kirshner 2014), in which FFIs might also have played an important role—but which my research does not explore.

What reforms, then, does my research focus on? First, as I will elaborate more below, it concerns China’s external liberalization: the openness of its financial system to foreign participation. Second, it concerns the development of Chinese equities—not in the Mainland (FFIs have had very limited *direct* impact on the way that Mainland stock markets have developed; see Walter and Howie 2012)—but overseas, in Hong Kong, New York, and elsewhere. Lastly, FFIs’ role, as outlined above, concerns the reform of China’s banks and financial diversification more generally. As will be described in chapter 5, FFIs have contributed to bringing the core ideas surrounding investment banking and private equity (PE) to China. The chapter will also touch on FFIs’ role in bringing the idea of insurance to China. These financial sub-industries were either wholly new or unheard of until Morgan Stanley partnered with China Construction bank, until AIG opened up a representative office in Shanghai, and until Wall Street PE firms made the trip from Hong Kong to Shanghai. More importantly, as chapters 4 and 5 will explain, China’s state-owned

banks' restructuring was heavily influenced by the PBoC's cooperation with the World Bank's International Finance Corporation and by the 1998 listing of China Telecom (later renamed China Mobile) in Hong Kong and New York and early experimentation with foreign incorporation and listings in Hong Kong in the early 1990s.

### *5.2.1 Counterfactuals*

Although we cannot clearly identify the *extent* of FFIs' contributions to China's financial evolution since the early 1990s until the beginning of the Xi/Li period, there is a need for a clearer abstraction of FFIs' contribution to the evolution of China's financial political economy. To this end, the present subsection will propose some potential counterfactuals of what the directions that the Chinese financial system might have taken, were it not for FFIs' interactions with China's policymakers and with China's financial markets.

Perhaps the most important change that FFIs have helped to institute in China was helping Chinese bank and non-bank SOEs tap the abundant global capital available in global stock exchanges, as well as the market scrutiny and corporate governance changes that necessarily accompany the listing of Chinese state-owned firms thereon. Chapter 4 will suggest that in 1997, Zhu Rongji's and then CCB executive Wang Qishan's cooperation in consolidating local telecom assets into a prototype 'national champion' called China Telecom (China Mobile, today) was the model on which China's SOE and state-owned banks' restructuring was based for the subsequent decade. Had this listing, as well as the subsequent oil SOEs and Big Four bank listings that followed, not gone as planned (if the capital raised was not sufficient to assuage Zhu's critics), what would China's financial markets and corporate sector have looked like?

One possibility is the strengthening of China's domestic stock exchanges and capital markets more broadly. China's QFII scheme implemented in 2003 was modeled on the Taiwan policy of the same name (Walter and Howie 2009). In Taiwan's case, however, foreign investors



had had to use this channel to acquire local companies. In other words, they had to invest directly on the Taipei Stock Exchange. As such, one possible outcome would have been a more pronounced role for the QFII channel not only for corporate governance reform (this channel would have taken the place of overseas listings) but also for the structure of the Mainland stock exchanges. As Chapter 4 shows, China's policymakers were able to put off 'fixing' domestic stock exchanges into the future because foreign financing was plentiful and easy to access via overseas stock listings. Not surprisingly, QFII investments have had little impact on China's domestic stock markets. However, had this been the only channel for foreigners to invest in Chinese SOEs in the late 1990s and early 2000s, we might have seen more radical stock market reforms, more capital flowing into these stock markets and, most ironically, a greater foreign share therein.

To put it another way, foreign capital might have played a greater role in China's domestic financial system had it not been for foreign investment banks' help in connecting Chinese national champions with global capital markets. Even more ironically, if QFIIs were the only channel through which foreigners could invest in Chinese SOEs, the quotas would have had to be increased substantially to meet the national champions' capital needs in the late 1990s and early 2000s. In this context, *capital account liberalization might have been pursued at a faster pace.*

Walter and Howie (2012) also suggest that the lack of privatization and the continued state dominance in the corporate and financial sector was aided and abetted by FFIs. And to be sure, my own analysis in this thesis supports their hypothesis that FFIs have had an important impact on the development of the modern Chinese financial and non-financial SOEs. As Chapter 4 will illustrate, the consolidation and rejuvenation of the state-owned sector following the East Asian financial crisis was orchestrated with the help of FFI guidance in listing these enterprises overseas and re-organizing their management practices along the lines of corporate governance principles accepted and understood by international investors.

But this is not to say that state involvement in China's banking or corporate sector would have diminished or that privatization would have proceeded faster had it not been for the

involvement of FFIs. For one, FFIs helped reformers to consolidate local state assets into large, national corporate entities—the ‘national champions’ strategy. Alternatively, it is possible that smaller corporate entities might have appeared instead of the corporate giants that we see today. Alternatively, we could have seen corporate governance principles and profit-seeking behavior introduced without the oversight of global markets—more gradually, as in the case of Korea or Japan (Scher 2001; Campbell and Keys 2001). The evidence presented in chapter 4 allows us to confidently say that FFIs influenced the size and pace of ‘marketization’ of Chinese SOEs, but we should be cautious about arguing that Chinese oil and telecom companies are an ‘invention’ of FFIs: Japanese and Korean corporate giants were built without the money and oversight of global stock markets.

Of course, unlike in the Japanese or the Korean case, China was faced with a profound non-performing loans (NPL) crisis in the late 1990s and looked as if it very much needed the financing available in New York and Hong Kong. However, China’s resolution of its NPL issue was carried out internally, by the offloading of NPL assets onto the books of China’s Asset Management Companies (AMCs).<sup>14</sup> Moreover, China’s banks (whose financing is the backbone of the national champions’ expansion) were eventually recapitalized by deposits from Chinese households—largely a private sector growth phenomenon—and helped along in no small part by the surge in Chinese exports following the country’s accession to the WTO (see Lardy 2014). As such, the financing made available to Chinese SOEs through their restructuring and listing abroad by FFIs only tells part of the story of China’s state-owned corporate resurgence of the 2000s. Moreover, China’s reliance on its state banks has far less to do with the help they received from FFIs than with China’s fiscal decentralization, which leaves not only the financial system but the entire fiscal system reliant on bank financing (Tsai 2004b).

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<sup>14</sup> The AMCs did not even begin to prepare for overseas listings until 2011/2012. See Chapter 4.

## 6.0 Conclusion

It was suggested above that China's experience with financial liberalization says more about the international financial system than about China itself. Far from an offhanded remark, this is one of the main themes underlying the present study. China's experience with financial liberalization demonstrates that the global financial system has a less liberal character, and might be much more politically neutral, than we might imagine. After all, global capitalism barely blinked as Chinese local governments and central bureaucracies, with the help of international investment bankers, lawyers, and accountants, sold minority stakes to global investment banks and pension fund managers in the same way that American private technology firms sell majority holdings of their *private* companies—side by side, in the same stock exchanges. The main goal of this chapter has been build a theoretical framework that furthers our understanding of how China has been able to make use of global markets and institutions without undergoing the process of rapid economic liberalization that many of its post-communist peers have opted for. China's interaction with FFIs not only reveals the actors' agency in China's financial evolution but also explains how the actions of non-state actors—as agents of global markets and economic practices—can be utilized by emerging economy policymakers, while maintaining the policy levers that limit these actors power vis-à-vis the state.

The foregoing chapter described that this thesis contributes to the study of IPE and to China studies literature in two ways. It offers an explanation of the distinction and relationship between liberalization and internationalization, which is not well understood in the literature on post-socialist transition and on the liberal international order. It defines internationalization as a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as

global cities or production chains. In the case of China's financial sector, internationalization is seen to take place through spatial and elite-based linkages. The chapter also frames the study of FFIs in China as an examination of the limits on the power of transnational financial actors: how conditions, contexts, and issue areas shape the efficacy of the action of transnational financial actors. I suggest that FFIs have encountered the problem of obsolescing bargaining (Vernon 1971), stemming from the processes by which China's financial system has been internationalized. The next four chapters will illustrate these processes by looking closer at FFI lobbying, their listing of Chinese financial and non-financial SOEs in global stock exchanges, and the process by which they transferred expertise to China's domestic financial institutions.

## Chapter 2: FFI Lobbying and China's WTO Accession

### 1.0 Introduction

When China joined the World Trade Organization in 2001, it made nine categories of commitments across a wide array of sectors promising unprecedented commitments to liberalize services (Lin 2003). Among them, the commitment to liberalize access to financial services stood as a particularly significant commitment to reform and greater integration with the global economy. Upon signing the accession agreement, policymakers in Beijing committed to allow foreign financial institutions (FFIs) to provide retail banking services in local currency in any locality and to all Chinese clients; FFIs were to be granted free range to provide advisory, depository, and lending services freely. After being barred from most geographic locations, from lending in RMB, and from incorporating domestically, FFIs were promised something approaching 'national treatment'—the right to enjoy the same privileges in conducting business as their domestic counterparts. In short, upon accession, FFIs seemingly won a decisive victory in China in 2001. The foreign insurance industry, while gaining much less in the way of market access through the WTO (the industry had, from the start, faced more market-based obstacles than regulatory and political ones), nonetheless also made significant strides upon accession.

This chapter will document how FFIs lobbied to create a favourable environment for themselves in China's domestic banking, equities, and insurance markets. It will demonstrate the various ways in which FFIs have attempted to act as a group to lobby for a seat at the table in Washington as the latter sought to influence China's drafting of regulations for the banking, equity, and insurance markets. It will show how FFIs sought to change the relationship between the state and private sector in China more generally. It will also show how FFIs acted collectively to

contribute to the broader lobbying effort of US businesses, which ultimately changed China's laws towards FFIs and furthered external financial liberalization in China. Subsequent chapters will outline the various ways in which FFIs have played an important part in the evolution of the Chinese financial system since the early 1990s.

As I will illustrate below, the foreign banks' role in US permanent normal trade relations (PNTR) negotiations with China provides an important illustration of FFIs' role in one aspect of China's financial evolution: the laws governing FFIs' activities in the country. It reveals a multifaceted approach employed by FFIs to influence their formal, legal environment in China. It included a lobbying strategy that leveraged their influence with their home governments as well as their linkages with elites in the Chinese government; it involved appeals to policymakers on normative grounds (on grounds that WTO accession will 'socialize' Chinese finance and insurance to look more as they do in the US); it also involved forming strategic alliances that stretch across industries, countries and issues. These will be explored in detail in section 5, while sections 2 through 4 provide a background of the negotiations and a literature review of FFI lobbying at the global and US level.

It should be noted that this chapter is intended as a review of secondary literature and a select number of primary sources. It is not intended to give new insights about the achievements of FFIs vis-à-vis US-China WTO negotiations. Rather, the goal here is to combine the literature on global FFI lobbying, with that of business lobbying in the US more generally, to provide inferences about the role played by FFIs in these negotiations. Where secondary literature does not give us a good guide, memoirs and congressional testimonies are added for illustration, but *not for establishing causality*. The goal here is to show how FFIs were active, not passive, actors in China's WTO accession, which concluded with significant legal and institutional opening of China's financial markets—external liberalization.

From a theoretical standpoint, this chapter will illustrate how FFIs fostered financial internationalization in China by fostering elite linkages between themselves and policymakers in

the US and China, leveraging their close ties to both. This has resulted in connecting the hitherto closed off Mainland financial sector to the liberalized and globalized financial system by legal and formal means: specifically, those inscribed in the WTO's General Agreement on Trade in (financial) Services section. In this context, foreign financial firms' lobbying efforts were one variable, of many, in changing China's legal environment in such a way that allowed foreign capital to play a greater role in Mainland banking, insurance, and capital markets. As this chapter will explain, this was made possible by China's desire to join the World Trade Organization. In this bilateral, state-to-state, trade talks scenario, FFIs' political bargaining position vis-à-vis Chinese policymakers was relatively strong, as the agency of pushing for the liberalization of financial services was passed onto the Clinton administration. Much of the work FFIs had had to do simply boiled down to helping to build the legislative coalition in favour of normalizing trade relations with China.

## **2.0 Background**

China's WTO accession process began in July 1986, when the PRC applied for accession to the GATT. Chinese officials engaged in bilateral, as well as multilateral negotiations—most significantly, with the US and the EU. The story behind China's accession to the WTO is well documented. For example, Devereaux et al (2006) recounts how both international and domestic factors have influenced US vacillation and eventual acceptance of China's membership in the World Trade organization. The most significant debates, of course, surrounded the broader normative debate about free trade as well as long-standing human-rights issues. Lobbying by a wide-variety of stakeholders, from labour to human rights groups proceeded throughout much of the 1990s, intensifying particularly in 1989, with the CCP's decision to crack down on Tiananmen Square protestors, and reaching a crescendo in the two years leading up to accession.

To be sure, the EU's role in China's WTO accession should likewise not be underestimated. Indeed, for the purpose of our analysis, it should be noted that European financial firms were no less important in lobbying their home governments to accept China's membership in the WTO (Schlichting 2008) and were among the first to gain licenses to open the first branch offices in Shanghai in 1994. However, Europe's debate was quite different from that which went on in US politics: it was much less confrontational, with the EU playing a more conciliatory role. Elgin (1997) has documented the process of the EU's involvement with China's WTO accession process and has concluded that Europe's different approach stemmed from the fact that in the EU granting China special developing country status (which gave it preferential tariff status) was a less politically charged issue.

This is why the US debate surrounding granting China's permanent Most-Favoured Nation status is especially significant. From the start, and up until the last days of the MFN debate, the decision to sign a trade deal with China was far from a 'done deal.' Indeed, domestic pressure played an important role in changing direction of negotiations at very critical moments. In 1992, President George H.W. Bush used his Presidential veto twice to reject an MFN Bill passed by both houses of US legislature, as the proposed law linked trade with human rights. President Clinton campaigned in 1993 precisely to keep such linkages in the yearly renewal of the law (Devereaux et al 2006). Some have suggested that, following a particular solidarity across a wide range of business groups and its resultant lobbying campaign by the business community—popularly named 'the new China lobby'—combined with an inability to influence China's human rights policy, forced Clinton to backtrack on his campaign rhetoric. But despite the seemingly unprecedented lobbying campaign by the business community, domestic politics would continue to line up against a final deal. While many of those opposed to the deal had long held that congressional politics and lobbying had lined up in favour of the deal (see, for example, Dreyfuss 1997), it is worth noting that congressional politics far from assured Clinton an easy victory. The Democratic minority in Congress long



opposed the deal and, joined with Republican concerns about national security, had made the President reject an agreement following a symbolic visit by Premier Zhu on April 7<sup>th</sup> 1999.

While Clinton came around to normalizing trade relations as early as 1996, the exigencies of American domestic politics made the process longer and more protracted than might be expected. Well into the last days of the debate surrounding China's WTO membership, Congressional Minority Leader Nancy Pelosi had resisted, arguing: "The Chinese government has a remarkably consistent record of violating its international commitments. Some argue that allowing China into the WTO will force them to play by the rules. The reality is that the Chinese government will not abide by their agreements if it is not in their interest to do so" (Pelosi 2000).

This made lobbying an important part of the process. Both sides of the fence in this debate had had to appeal make appeals on various fronts. Labour groups made pleas not only on the issue of wages and 'Chinese mercantilism' but also reached across to human rights groups and, more surprisingly, to conservative Republicans concerned about national security issues and to the old China lobby—the pro-Taiwan lobby groups. Business groups also forged unexpected coalitions with Congressional democrats and even some human rights groups in China to press the case on normative grounds—arguing that improving human rights causes are best served by promoting economic openness in the country (Devereaux et al 2006). With respect to financial services, the road to opening China's financial sector was an even longer and more protracted process, requiring not only building coalitions and trying to frame the debate at home, but engaging and negotiating with governments and financial sector countries in other parts of the advanced industrialized world—most significant with the European Commission and European banks and insurers.

Inclusion of services in the GATT (and furthermore, the financial services agreement) was a protracted and uncertain process, involving a large constellation of state and non-state actors. Lobbying for a financial services agreement alone was a protracted process that involved resolving a fundamental disagreement on the extent of liberalization between the US and the EU (Woll 2002). As will be detailed in the next section, fundamental differences existed between European

policymakers and American ones—on how much liberalization to write into the WTO financial services agreement. Further complicating the issue were the wide divergences of opinion between advanced and emerging economies. Indeed, while some have suggested that international regulations are made by the most powerful state actors (or quasi-state entities like the EU) (Drezner 2007), emerging market economies in Asia were reluctant to accept measures for liberalization until the East Asian financial crisis of 1997-98 provided the impetus for liberalizers inside these countries to press ahead with financial liberalization (Dobson and Pacquette 1998). This was especially true for China, where the crisis in neighboring countries provided the impetus for policymakers to undertake politically difficult financial sector liberalization policies (Wang 1999). Indeed, Premier Zhu Rongji—a long-time proponent of financial sector liberalization—had himself underscored the importance of the crisis in creating the needed push for China to agree to important financial sector provisions in the WTO (Zhu 1999).

Thus, for the financial sector, the process of advocating for a more globally open financial services in the WTO articles of agreement did not begin nor end with lobbying the US government to normalize trading relations with China. But the US government was a very important lever that financial firms pulled (and continue to pull) when doing business in China's banking, insurance, and capital markets (as Chapters 4 and 5 will make mention of). But in the lead-up to China's financial sector liberalization via its membership in the WTO, it was impossible to pull that lever without simultaneous engaging not only the Chinese, but also European policymakers, as well as a host of business groups also lobbying for market access in China. Lobbying by financial firms takes places in a variety of ways, and these ways are geographically distinct. Typically, lobbying takes place within a particular institutional context (i.e. within different legal and political environments). The following two sections will outline lobbying in one context and in the Chinese and American. The goal is to build a framework for understanding how global financial players mobilized support in China and in the US for financial services liberalization in China.

### 3.0 Lobbying in China: a Short Review

The WTO agreement is a multifaceted document that includes stipulations to liberalize trade in large number of areas. In China, opening the financial sector to foreign participation has always been a sensitive political issue. Therefore, to move Chinese policymakers towards the emerging global consensus in this area (see Woll 2002; Martinez-Diaz 2009), FFIs needed to create a good amount of good will and mutual understanding between themselves (the agents of this consensus) and Chinese policymakers in order to make the latter more amenable to this section of the WTO agreement (Schlichting 2008). The linkages between Chinese policymakers and FFIs will also be explored in the next chapter, as well as in chapter 5. This chapter will begin this discussion with a focus on the WTO agreement.

To be sure, a direct causal argument linking FFI lobbying and WTO negotiation outcomes will not be made. This would require a multidimensional analysis of domestic politics in the U.S., China, and would fully take into account of the politics of China, the U.S., and of international forces—notably the 1997-1998 East Asian financial crisis. Instead, this section will describe how global financial services firms employed lobbying as a tactic (one of several), to expand their presence in China's political economy. The goal is here being to construct a framework for understanding how key US financial institutions approached, or 'lobbied,' for access to China's financial services industry leading up to China's WTO accession in 2001 and how this ultimately proved to be one of the ways they have come to play an important role in affecting China's financial evolution since the early 1990s. As will be explained in subsequent sections, it is difficult to separate bilateral-based lobbying—that is, the lobbying of the US to, in turn, press China's government for market access—from a multi-channel lobbying tactic that involved linking US and Chinese policymakers together by cultivating institutional and personal relationships with both (see the section on *triangular alliances*). Therefore, lobbying must be explored in a more global context.

To begin, it is important to define what ‘lobbying’ means in the context of my analysis. The strategy referred to here is distinct from an issue-based one—one that seeks to block regulatory initiatives by states and international organizations (e.g. see Pagliari and Young 2013). It is closer to what Boddewyn (2007) calls an “offensive” strategy—one that seeks “dimensions related to opportunities for enhancing incomes, assets, social responsibility, and moral leadership.” Even though FFIs might ultimately be motivated by material considerations (increasing shareholder values, return on investment, etc), it has long been evident that they cannot stay politically or culturally aloof, either at home or abroad when ‘dealing with China’ (Paulson 2015).

This often means becoming “political activists” and “building their own constituencies” in order to attain these material motives. (Drucker 1980 cited in Boddewyn 2007, p. 161). This often leads to business strategies taking on lives of their own, often becoming removed from the material *raison d’être* of their organizations. This is especially true in China, where financial services firms have had to do more than simply advocate for favourable policies, focusing instead on cultivating key alliances with reformers and training the nascent financial services labour force in Western financial best-practices (Schlichting 2008; Robertson 2015).

Because leveraging access to global capital is not always the most viable strategy in a financially closed emerging economy like China (although, in the late 1990s and early 2000s this was not the case, as chapter 3 will show), and because the rule of law is not developed enough to assure some measure of predictability of regulatory initiatives, firms must rely on social capital and legitimacy to conduct offensive lobbying (Boddewyn 2012). Firms must be persuasive politically, socio-economically, and normatively. With respect to the first, scholarly literature has widely documented the ways in which firms have practiced government affairs in China in the 1990s, leading up to the country’s WTO accession (for example: Sanyal and Guvenli 2000; Luo and Park 2001; Chen 2004). These early sets of literature provided important insights into how China’s distinct ‘socialist market economy’ forced firms to integrate government relations into the core of their business strategy. Firms essentially ‘lobbied’ local and provincial governments because

influencing business policy formation was less a sectoral responsibility than one belonging to the individual firm (See, for example, Chen 2004). More recent studies of foreign firm lobbying have drawn more solid conclusions about how we should understand the lobbying behavior of foreign firms in China. The most relevant conclusions to be drawn from the relevant literature is that, 1) in China, managing corporate lobbying is a process that involves putting government relations departments and strategies at the centre of managerial practices; and that 2) as Deng and Kennedy (2007, p. 105) conclude, “MNCs do have to utilize *guanxi*, but they draw on a larger toolkit, which includes leveraging their technological expertise and their home-country governments”.

Lobbying by global financial firms is not well documented in existing literature and the publicly available evidence is very scarce, with only a number of anecdotal examples suggesting that its impact may have been significant (e.g. Chen 2011). As Schlichting (2008) notes, Henry Paulson had visited China 68 times between 1992 and 2004. HSBC and Standard Chartered, who have been key financial institutions in Shanghai throughout much of the 20<sup>th</sup> century (and remained on the Bund—China’s historical financial district—even throughout the Cultural Revolution), have cultivated important political alliances when such were absolutely crucial (for instance, in the 1980s, when foreign banks conducted limited to no business and were restricted to opening representative offices (Chen 2011)). Maurice Greenberg, long-time CEO of AIG and advocate of U.S. trade with China, is famous for engaging in this brand of what could be termed *cultivation* lobbying. In a congressional hearing in 2000 on the issue of granting China permanent normal trade status in U.S. law, he noted: “I first visited China in 1975, and have been back just about every year since” (Greenberg 2000).

Schlichting (2008, p. 117) calls these regular visits a display of “deep commitment.” Some deep commitment visits are rather high profile, such as the meeting between then-President Jiang Zemin and Citibank CEO Stanford Weill in 2002 on the 100<sup>th</sup> anniversary of the bank’s presence in China. The meeting inaugurated Citibank’s Shanghai branch as the first foreign bank entity to offer foreign currency services to Chinese business and individuals. At the event, Jiang promised,

on the heels of WTO accession, to continue to open China's financial sector to foreign participation and, as the People's Daily noted, "expressed the hope that the Citigroup would continue to actively participate in China's modernization" (People's Daily 2002). Indeed, some financial firms—particularly smaller ones—spend many years on the ground in Shanghai or Beijing before landing a contract, partnership or viable independent operation. To be sure, the nature of lobbying in China is changing and success in the Chinese market is increasingly less dependent on personal relationships with regulatory authorities. As Murray King, a managing director of APCO Worldwide's Shanghai office, has noted "Too many companies suspend their typical due diligence when they enter China... The key is to use the same processes that you'd use in any other market. It seems logical but you'd be surprised at how often that doesn't happen" (quoted in Judd 2008, p. 7). This is, however, not to take away from the importance of interpersonal relations in the 1990s, when China was negotiating a permanent trade agreement with the US.

To sum up, there is currently an abundant and burgeoning literature on the nature of private sector lobbying in China. And to be sure, the excellent overview by Elizabeth Schlichting (2008) in her survey of the very rapid internationalization of the financial sector in China, has provided an important window into understanding how foreign banks try, to varying degrees of success, to exert influence on policymaking in China (with the aim of further opening China's financial markets and retail banking services). But even though the foreign financial sector in China remains one of the most 'global' of all non-state actors, existing literature does not provide a systematic overview of their role in the key and pivotal debate that led up to China's membership in the WTO.<sup>15</sup>

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<sup>15</sup> Schlichting's study does provide a short (2 page) overview of the debate surrounding China's WTO membership and the US and the financial service sector's role therein. The most important contribution here is her observation that, throughout the negotiations, "European firms were perceived to have much more clearly articulated interests in opening Chinese financial markets, whereas American firms were perceived to be comparatively reluctant to push issues, a tendency that may have been due to the booming market in the US at the time of negotiation as well as a stronger perception of risks in EMEs in the aftermath of the Asian financial crisis." However, she does not provide very much substantive evidence to explain this statement.

Even more so, what is missing is an analysis of how financial firms lobbied the US government specifically, to push for China's accession into the WTO—that is, their role in the negotiations on China's WTO access. Schlichting provides a detailed analysis of how FFIs lobby for market access in China, she gives the WTO negotiation process a rather brief review, even though she acknowledges that “China's entry into the WTO and the related financial market commitments have been the largest single step in opening the domestic financial market” (Schlichting 2008, p. 128). Beyond Schlichting's otherwise nuanced and revealing overview, while the literature surveying the lobbying of US businesses more generally on China's WTO accession is abundant (Dietrich 2000 and Devereaux et al 2006, for example, provide an excellent overview), the role of the financial sector in the WTO lobbying process is poorly understood. This is not surprising, as financial firms seldom acted as a niche interest group and more commonly allied—or even led—business industry associations in pushing for normal trade relations with the PRC and, ultimately, its WTO membership. However, it is difficult to understand the behaviour of international financial industry actors in China without a clear picture of how FFIs leverage government-to-government relations to ensure market opening in China. To this end, looking at the GATS agreement that was negotiated throughout the 1990s goes some way in helping us to answer that question.

#### **4.0 Lobbying in the US**

This section provides an overview of how FFIs inserted themselves into the legislative process in the US during the Congressional debate on President Clinton's negotiations with the

PRC on the conditions of the latter's accession to the WTO. The goal of this section is to review the literature on FFI lobbying for financial liberalization at the global level and to integrate it with the literature on business interest group lobbying in the US for China's WTO accession. The aim here is not to provide new evidence on how FFIs lobbied members of the US congress to vote with the Clinton Administration on China's accession—this is the goal of section 5—but to combine these two separate sets of literature in order to contextualize FFIs role in US-China negotiations.

Susan K. Sell (2000) has provided an important overview of the role of the financial sector's lobbying efforts via the broader effort by global service sector firms to solidify the GATS in the WTO agreement. Sell has shown how European firms cooperated with US and UK firms in the mid-1990s, eventually forming the Financial Leaders Group to align their interests and to more effectively address financial services trade issues across very diverse political systems (namely the European Commission, the US, and the UK). Woll (2006; 2012) and Woolcock (1998) have gone further to emphasize the role of the private sectors in different countries in eventually bringing together an agreement that would affect not only the wealthiest OECD economies, but (and perhaps more significantly) emerging economies with more closed financial sectors.

Predictably, the US and UK negotiators were the most insistent on greater liberalization, as the financial sectors in these economies already operated in some of the most liberalized regulatory environments in the world and sought to change the policies of other WTO members along the same lines. Acting through the US Coalition of Service Industries and the UK International Financial Services London association (formerly, the British Invisibles), firms like Goldman Sachs, Meryl Lynch, Citicorp, AIG and Barclays "established command posts" near the WTO headquarters and aggressively pushed for financial services liberalization to be maximized in the GATS (Andrews 1997 cited in Woll 2007b). As Woll (2007b) points out, the European Commission had to push European firms to enter negotiations more aggressively in order to moderate the US and UK positions, suggesting that European financial services firms were much less keen on 'opening up' financial services industries across the world than were their Anglo-



American counterparts. As Wesselius (2002) further showed, financial services groups were key to the services liberalization negotiations leading to the 2000 GATS agreement and that, furthermore, the key lobby group, the Financial Leaders Group, was dominated by US companies. Ultimately, what was achieved by the end of the negotiations mirrored American demands in many respects, albeit giving countries prudential regulatory exemptions from the agreed upon provisions towards ‘national treatment’ of foreign firms and liberalization of services.

However, as Woolcock (1998) had argued, the outcome of greater opening of financial services across WTO members was not simply the outcome of successful lobbying. The biggest achievement—at least on paper—of the final GATS agreement was the acquiescence of emerging markets to the national treatment and liberalization provisions. Writing at the time of ongoing negotiations, Woolcock concludes that “providers of financial services are finding ways of gaining access to many new markets, even without the benefits of a multilateral agreement guaranteeing rights. The GATS negotiations on financial services are therefore moving with the flow of policy developments in most countries” (1998, p. 36). Most significantly, it should be added, the impact of the Asian financial crisis and the unraveling of many emerging markets financial systems at the time played a key contribution to changing the stance of many emerging market economies towards financial sector liberalization. This is especially true of China, where reformist factions of the CCP took advantage of a crisis at their bordered to push for restructuring of its financial institutions through various measures of liberalization (Wang 1999).

From these studies, we can infer three important observations about the characteristics of US financial sector lobbying on the opening of China’s financial markets. First, FFIs used their offices in the US to influence the negotiation of the financial services provisions of the GATS. Because the US round of negotiations was the defining one in China’s WTO accession, with the negotiators representing other countries taking the US-China agreement as a blueprint (and often a carbon copy) for concluding their own negotiations with China (Lampton 2001), the lobbying process in the round involved not only American FFIs but European ones as well. Second, FFIs

were apparently keen to affect the trade policies of emerging economies and are quite aggressive about shifting the paradigm of market openness towards the Anglo-American global financial paradigm. With respect to China, this is borne out by congressional testimonies, where industry representatives argued that WTO financial services provisions are a crucial bridge to realize opportunities for US firms to expand their business in the country (Lampton 2001). Third, while it is clear that financial sector actors found bilateral-based negotiations important and that the WTO became an important tool for opening markets in emerging and advanced economies alike, it is still unclear how China fit into this broader strategy. As the following two sections will show, US and European financial firms saw China's WTO agreement as a way to 'socialize' China's financial markets and, to achieve this socialization, they sought broader allies in the wider business community and appealed to open China's financial sector on 'normative grounds'—by appealing to the case of free trade.

#### *4.1 Lobbying in Context*

FFIs' lobbying role lay in their capacity to convince US policymakers of the merits of more closely integrating Chinese financial markets with those of the US. In 2001, the US House of Representatives held a hearing of the US-China Security Review Commission to review the security implications of Chinese companies listing in the US and of US financial firms doing business with state firms in China. Given the national security-obsessed post-9/11 environment in Washington, policymakers sought to explore the implications of doing business with Chinese firms that might be linked to the interests of China's People's Liberation Army (PLA), or those of the Chinese government more broadly. In a December 6 2001 hearing, on the eve of WTO accession (China would officially join the organization five days later), prominent US financial firms testified urging US officials to ease their worries. The common line of argument that ran through each firm's testimony was the ways in which membership in the global financial system and exposure

to (US-led) global accounting and other financial practices would lead China to change its behaviour. For example, then Vice-Chairman of Goldman Sachs International Robert Hormats urged that subjecting Chinese firms to added security scrutiny would prove to set back financial sector reforms in China. Another representative from the industry spoke of the “socializing effect” of market opening in China, and described how market opening would make managerial practices in China conform to those in the US (US-China Economic and Security Reform Commission 2001, p. 701).

Maurice Greenberg of AIG has also stated that “over time, the presence of U.S. and other foreign insurers will bring to China the modern management tools necessary to develop a competitive, world class insurance industry. This will give China the ability to more efficiently manage risks throughout its economy and society. And, with it will come the benefits of choice, lower prices and product innovations to meet the needs of Chinese consumers” (United States Congress 2000).

While political winds in both China and the US had coalesced in their favour (as demonstrated above), it is difficult to imagine how the financial services sector could ‘add value’ to existing debates on human rights, bilateral US-China relations, and national security issues. And key actors in the debate of China’s WTO accession had, very early on in the debate, understood this (Dietrich 1999). There is insufficient evidence to show how (if at all) financial firms made a direct appeal to US lawmakers—or, for that matter to the public—on the narrow issue of liberalizing China’s banking, insurance, and capital markets.

Instead, the US example demonstrates how FFIs also acted as agents of China’s policymakers defending China’s financial reforms against US congressional action that may have set them back. Certainly, China’s financial industry was frequently discussed in congressional hearings and in official speeches, but it was seldom mentioned outside of the broader context of promoting trade in goods and services. Pagliari and Young (2014) suggest that, despite their ‘wealth’ relative to other lobby groups, bankers, insurers, and fund managers lack normative and

moral arguments necessary to push a policy agenda alone. Typically, they require strategic alliances (as will be detailed in the next section) with other interest groups to push a particular agenda. For example, in resisting the regulation of financial derivatives, the financial sector relies on alliances with agricultural groups and homeowners, who significantly benefit from the use and proliferation of financial innovation (Pagliari and Young 2014).

Moreover, because finance is a highly specialized and complex field, policymakers often rely on the industry itself to formulate policy.<sup>16</sup> While this is increasingly true of any industry, the case of financial firm lobbying US policymakers to open Chinese financial markets illustrates an especially profound effect of this well documented phenomenon. Understanding the politics and institutions driving financial reform in China is a topic that interests very few domestic interest groups in the US. And while the constituency for this knowledge has been growing (due in part to the impact of the global financial crisis), the 1990s saw this knowledge as an almost exclusive domain of banking and insurance firms themselves—that is, their own analysts and on-the-ground employees in China. At the congressional hearings, the point of contention was largely a normative one, with an AFL-CIO representative asking policymakers to press for more labour rights and fair competition in China, and with a CATO institute representative asking for more demands to spur privatization.

And on the whole, the approach of financial firms throughout much of the WTO negotiations process was one of supporting the rest of the business groups' efforts to gain a trade deal with China as quickly as possible. However, as Dietrich (1999) has noted, the outcome of the WTO accession is difficult to see as an outcome of a successful lobbying effort. As trade with China became more important over the course of the 1990s, the general political tide was increasingly shifting in favour of de-linking trade from human rights. The financial sector made good use of this development—and of the Asian financial crisis—to emphasize the point that US

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<sup>16</sup> In the case of finance, see Caprio and Levine 2012; Underhill and Zhang 2008; for lobbying more broadly see Esterling 2009.

financial expertise (which was then being employed to restructure Chinese banks and to address the issue of non-performing loans) was necessary for China's further integration into the global economy.

But for the financial sector, the devil was always in the details. The key question was not over whether or not the agreement would be signed, but how far the practical gains in market opening would be made. The WTO's section on financial services, under the General Agreement on Trade in Services (GATS), gives signatories much room to maneuver in applying financial sector opening provisions. Most importantly, the GATS vaguely allows policymakers to use "measures ...for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system" (cited in Gao 2007, p. 13). During the 1990s, US financial firms lobbied to ensure that, once a free-trade agreement was signed, they would be well positioned to ameliorate the impact of this provision on their business. The next section explores the strategies employed to this end.

### **5.0 Alliances-based lobbying.**

During the debate and negotiations on China's WTO accession, two kinds of coalition-based strategies were utilized by the financial sector, as they pushed for the U.S. to permanently normalize its trade relations with China, and the latter's WTO accession: 1) triangular alliances that involved themselves, U.S. Policymakers and key Chinese policymakers; 2) and cross-issue alliances—that is, bandwagoning on the normative and moral claims made by groupings whose aims have moral and ethical resonance with policymakers.

### *5.1 Triangular alliances*

The US financial industry was no stranger to advocating on behalf of free trade with China. For instance, two high profile Goldman Sachs and Goldman Sachs International executives respectively, Henry Paulson and Robert Hormats, were very prominent advocates of China-US trade and played important in helping Chinese policymakers liberalize the country's financial sector. Similarly, Maurice Greenberg—long-time CEO of AIG was deeply involved in China's MFN debate and was one of the key participants in re-introducing the insurance industry to China. Hormats and Greenberg both testified in US Congressional hearings on China-US trade, with Greenberg appearing as one of the key proponents of making normal trade relations between the two countries permanent and Hormats being a key voice in communicating the intentions of Chinese leaders to the U.S. public (Sanger 1999, Council on Foreign Relations 2001).

The focus of this study is not US politics and as such, it is more relevant to focus on the outcome of lobbying on external financial liberalization in China, rather than on the motivations of FFIs in the US. As mentioned above, the goal of this chapter is to give an overview of FFI lobbying in the negotiations that led up to China's WTO accession: to review the literature on FFI lobbying and to supplement it with publicly available Congressional testimonies, news sources, and press conferences where available.

While the immediate audience of US financial sector firms might have been American lawmakers, the success of a trade deal with China also hinged on overcoming two important obstacles. One was convincing both Chinese reformers and, indirectly, conservative factions within the CCP, who were highly skeptical of allowing US firms (and not just financial firms) more rights to invest in, and sell their products to, China. Premier Zhu Rongji (2011) makes allusions to this in a number of interviews, noting that financial sector opening is a politically sensitive topic. The second was the complex process of state-to-state negotiations themselves. China wanted market access for industrial goods, apparel, and agriculture in the US. In return for this access, Zhu Rongji

needed to convince Chinese conservatives that giving way on telecom and finance was a worthwhile exchange.

This, in essence, suggests the complexity in FFIs' agency in nurturing and tapping into the *triangular alliances* that included themselves, US policymakers and Chinese reformers. Linkages at the elite level were nurtured throughout much of the 1990s to create good will from sympathetic members of the CCP. Likewise, US legislators—skeptical of China's human rights, environmental, and labour record (or simply responsive to interest groups in their ridings)—had to be swayed to vote with the Clinton administration. As with many reforms that integrated China closer with the global economy, financial sector opening was a piecemeal process that required convincing central government policymakers of the benefit of liberalization. This process of swaying the minds of policymakers at various levels across China created linkages—both institutionalized and informal—between Wall Street firms and what would become key allies in China. As described in the introduction, I describe FFIs actions in this regard as those contributing to financial internationalization through elite linkages.

One example of such linkages is the International Business Leaders Advisory Council, created by then mayor of Shanghai Zhu Rongji in 1990 to advise on the modernization of Shanghai. AIG CEO Maurice Greenberg, who would personally help to recruit other international firms to join, chaired the council. As Greenberg recalls, this was a necessary step in eventually being granted a license to sell insurance in Shanghai—a milestone that was attained through personal contact with each member of the Politburo Standing committee (Greenberg and Cunningham 2013). As Lampton (2002) notes, Greenberg was among the key figures in bridging the divide between Chinese and US policymakers. On the Chinese side, he worked to make opening the Chinese economy to foreign investment palatable to skeptical members of the CCP. For example, in the 1970s and 1980s, Greenberg repeatedly approached China's SOE insurance managers to express his intention to help modernize their operations (Greenberg and Cunningham 2013). As both Greenberg (Greenberg and Cunningham 2013) and Paulson (2015) explain, before their institutions

could even set foot on the ground, they had to engage in goodwill partnerships (essentially, expertise-transfer arrangements) before skeptical CCP members would begin to appreciate the potential benefits of financial sector opening. Still, as Zhu Rongji repeatedly noted in his interviews with the press, his opponents at home saw a trade deal with the US as entirely one sided—with China making all the concessions on market opening without any significant concessions from the US (see Zhu 2011).<sup>17</sup>

On the US side, Greenberg sought out a multitude of channels to exert influence on US trade policy, including heading the US-China Business Council, and holding a post on the President's Advisory Committee for Trade Policy and Negotiations. Goldman Sachs's Paulson and Hormats played similar roles, albeit (during the 1990s) in a less high-profile capacity. American banks were instrumental throughout the late 1990s in helping China to transform in financial system following the Asian financial crisis.<sup>18</sup>

This dynamic can be conceptualized as a *triangular* type of lobbying because it relies on bridging both ideological and other policy divides between US and Chinese policymakers on key issues that ultimately define trade policy and other forms of policy cooperation and coordination. The cases surrounding individuals like Paulson, Hormats, and Greenberg are important because they illustrate that lobbying the home-country government through official channels is seldom enough to achieve concrete goals. Indeed, Paulson's (2015) memoir suggests that much of the key lobbying victories were achieved behind closed doors. Because of the limited impact that any one sector (by itself) could have had in swaying the outcome of WTO negotiations (Dietrich 1999), key members of the banking and insurance industries positioned themselves as key facilitators of bridging the divide between policymakers in both countries. This triangulation was important because it also aimed at getting American firms (and in particular, firms that inserted themselves

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<sup>17</sup> Interestingly, this was the key message from the US business community throughout the entire debate surrounding normalizing trade relations with China in the 1990s.

<sup>18</sup> This was only a small part of their much larger role in aiding China's financial restructuring throughout the late 1990s and early 2000s. This will be detailed in the next chapter.



into this triangle) more favorable regulatory treatment under the auspices of a trade agreement.<sup>19</sup> This strategy, however, was only made available to a select few China-savvy members of Wall Street (Paulson 2015; Chen 2011; Greenberg and Cunningham 2013). In some respects, the strategy also precluded collective action by the wider financial industry, which in many ways exhibited tendencies toward market competition rather than industry-wide coordination.

## *5.2 Cross issue alliances*

The most common lobbying strategy—especially when it comes to bilateral-based lobbying—is reliance on creating institutionalized ties between trade associations, governments, and industry members. In the US, the financial sector is represented in various horizontal forums (with respect to advocacy on market access and regulatory issues in China), most significantly by the US Chamber of Commerce and the US-China Business Council. Furthermore, a cross-industry association organization called the Business Coalition for US-China Trade, formed in 1991 when the status of normal trade relations with China were seen to be in jeopardy, included industry associations like the aforementioned USCBC, AMCham, among others (Lampton 2002). These groups became the crucial vehicle for gaining access to China’s financial services sector, because they allowed American banks and insurers a political channel for advancing their interests in the country. This was important because, while the case for opening China’s financial sector was relatively uncontroversial in the US, lobbying for it outside of the framework of normalizing trade relations with China would see little traction, as Chinese policymakers were reluctant to give up levers of their financial system, even as part of a broader WTO package.<sup>20</sup>

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<sup>19</sup> Greenberg and Cunningham (2013), for example, recall how AIG came close to obtaining a nation-wide license in 1999 but fell short when Clinton’s refusal to sign a tentative WTO accession deal upon Zhu’s visit to the US that spring. Indeed, Greenberg made a personal concerted effort to press then successive Treasury Secretaries Robert Rubin and Larry Summers to convince Clinton to sign a deal and received assurances just prior to a last minute collapse of a final agreement, which was the backbone of his hope to obtain a 100% AIG-owned national license to sell insurance (see Greenberg and Cunningham 2013, Chapter 8).

<sup>20</sup> This was evidenced by the fact that this area remained contested well into the last minutes of the negotiations process (Devereaux et al 2006).

Pagliari and Young (2013) have provided a useful outline for understanding how financial sector actors are able to leverage complimentary interests with actors in other industries to pursue their interests in fighting or promoting regulatory initiatives. An important observation here is that “Joining forces with groups from different sectors allow a targeted financial group to gain political contacts and to increase its capacity to establish new privileged channel of access to the policymaking process” (Pagliari and Young 2014, p. 585). These privileged channels were important because gaining greater access to China’s financial sector industry was in many ways a process of normative contestation in China.

As Zhu Rongji recalled in April 1999, at a banquet hosted by the Economic Club of New York, the US-China Business Council, and the Chinese Chamber of Commerce, allowing foreign firms to open branch offices and set up commercial operations in Shanghai (where he was Mayor in the 1990s) made him appear as a ‘traitor’ to other members of the CCP (Zhu 1999). Thus, it was important for US firms to leverage the momentum created by US-China trade negotiations to exact the best possible concessions from Chinese policymakers. And indeed, while the “under-institutionalised and opaque nature of the lobbying processes in China make it a difficult endeavor” (Schlichting 2008, p. 115), the US provided opportunities for financial firms to be an influential part of the negotiating process. That is to say, while in China, institutionalized and organized representation of private interest remained subdued (Kennedy 2005, Deng and Kennedy 2007, Tsai 2004), in the US, the case was just the opposite.

Indeed, given the multiple channels available for American firms to advocate for their interests on any piece of legislation, American financial sector actors were able to leverage a consensus among business groups on the subject of ‘opening China’ and to press for their own interests. While it is unclear whether, in Hula’s (2000) characterization, financial firms represented ‘core members’ or ‘players’ among other business groups (whether they framed the issue or joined the cause), the importance of financial services to the deal suggests that their role in the WTO debate was pivotal. After Zhu Rongji’s multi-city tour of the US in the spring of 1999, the business

community rallied in support of a deal with China (Zhu 2011). This gave an important boost to financial firms' lobbying power: it inserted their core demands into the broader package being negotiated by the USTR team in China. And indeed, the significance of financial services provisions was underscored as many perceived the final deal between Chinese and American negotiators to have been held up by a lack of agreement on trade in services—namely telecommunications and financial services, with the latter being reported as the greatest point of tension (Crosby 2008).

This made cross-industry consensus especially important for the US financial sector, as it kept the pressure up on US negotiators to conclude a deal, despite a broad agreement across a wide-range of sectors beyond finance and telecommunications (Lampton 2002). Moreover, much like in the negotiations leading up to the conclusions of the financial services section of the GATS, US negotiators faced a team of Chinese negotiators who represented a financial sector that wanted little in the way of access to the US market. A broader case had to be made, on the part of US negotiators to their Chinese counterparts, of the benefits of deeper global economic integration (Devereaux et al 2006). Thus, for *most* FFIs, who lacked the access to the Chinese leadership of AIG or Goldman Sachs, getting behind the cross-industry push for free trade was crucial.

But more crucial to FFIs' success in the lobbying process was what Cornelia Woll refers to as the interdependence of interests between the Clinton administration and their own. Woll (2007b) has found that while power or influence in lobbying process is difficult to measure—qualitatively or quantitatively—and while the 'success' of lobbying is difficult to deduce from the process or outcome of lobbying, the most important variable in determining the success or failure of lobbying efforts is an interdependence of interests between policymakers and lobbying agents. This was precisely the case in FFIs' lobbying of representatives in the US congress in the 1990s. Indeed, it was not the Clinton administration's negotiating team that they had to sway—the President was strongly in favour of China's membership, and needed to persuade members of Congress to push his agenda through (Lampton 2001)—but individual members of Congress, and

the Chinese negotiating team, which pushed back on the substance of trade liberalization in a number of areas. Indeed, to quote Woll's (2007b, p. 73) description of FFIs' role in the GATS agreement in the WTO's Uruguay Round, they "offered financial, legal and technical support, which the US negotiating team much needed in order to advance its other goals." In effect, they were swimming with the tide. But because the negotiations were delayed so long, and because they nearly broke apart in the end (indeed, one of the last outstanding contentious issues were financial services), FFIs effort (and money) surely played an important role in tipping the scales in favour of China's membership.

Therefore, cross-issue alliances can be considered to be the chief strategy to the US financial industry's lobbying on securing China's membership in the WTO and, ultimately, greater access to the country's financial sector. When then-President of the U.S.-China Business Council, Robert A. Kapp, testified to convince legislators to amend the 1974 Jackson-Vanik Amendment to give China permanent normal trading partner status, he made no effort to appeal to U.S. commercial interests or any broader notion of the national interest (whereas labour unions and human rights activists did in fact make such appeals; see, for example, United States Congress 1998,; 1999, 2000a). Testifying in front of the Ways and Means Congressional Committee in Washington D.C. on May 3 2000, he made the case for normalizing trade relations as a way to promote human rights in China, citing an article published by Chinese journalist and dissident Dai Qing, who earlier that year wrote an article in favour of more open trade relations with the PRC. The argument, just as much of the USCBC's claims had been throughout the 1990s, stressed the notion that China's integration into the global economy would strengthen human rights and environmental standards in the country. Isolating China, so went to the narrative, would only aggravate the authoritarian nature of the regime (See United States Congress 2000b).

However, unlike other examples of lobbying—particularly those surrounding domestic regulatory issues—the advocacy effort in question did not involve making concessions with rival lobbying groups. Rather, the question of China's WTO membership was one of a culmination of a

decade-long effort that saw them through negotiations with European and East Asian governments, as well as Chinese authorities. As mentioned above, early on in the lead-up to the formation of the WTO, financial service firms formed a coalition to have financial services included in the WTO articles of agreement. In a WTO hearing before the Congressional Subcommittee on Telecommunications, Trade, and Consumer Protection, Brant W. Free, Senior Vice President International External Affairs for The Chubb Corporation (a U.S.-based multinational insurer) and member of the Coalition of Service Industries described:

Within the Coalition there is a separate financial services group. In building support for international agreements, we have developed a financial leaders group which includes the CEOs of financial firms from Europe, North America, from Latin America and Asia. But when we raised financial services after crossing all of these other barriers, we were told financial services were so different they couldn't be in the GATT either, but ultimately succeeded (United States Congress 1999)

The successful inclusion of financial services into the WTO agreement effectively precluded the need for lobbying to open China's financial sector separately. By the time the question of permanently normalizing trade relations with China came to be debated in the US House of Representatives, the US negotiating team had already accepted their position.

As such, the financial sector was able to rely on the White House as a firm representative of their interests. By 1999, with the GATS set to be enshrined with full financial services provisions in the WTO agreement, the lobbying to open China's financial markets was fully submerged in advocacy for free trade and more open economic relations with China. The financial industry used high-profile and Clinton administration-connected representatives like Robert Rubin, who took a position at Citigroup following his post as Treasury Secretary, to testify on a multitude of issues,

from free trade, to human rights and the environment (United States Congress 2000b). However, throughout the various congressional testimonies given by Rubin, Hormats, Free, and others, financial services were seldom mentioned as core issue of debate. When they were, it was only to underscore the broader case for free trade. Indeed, the most extensive mention of financial services was by chief trade negotiator with China, Charlene Barshefsky, suggesting that key lobbying efforts on financial services alone (as described in the above section) were done in China.

To sum up, given the growing tide in favour of normalizing trade relations with China in the late 1990s, financial service firms could best make their appeal by allying with other business associations, via their association with the US-China Business Council (USCBC), the American Chamber of Commerce (AMCham), and others. Indeed, lobbying on normalizing trade relations with China drew in a variety of interest groups (including a host of human rights NGOs, business and agricultural groups, as well as the Taiwan Lobby), Wall Street's representation was buried within broader industry associations. This suggests a great deal of consensus among business groups on the China issue, which appeared to have precluded a narrower Wall Street centered lobbying campaign.

## 6.0 Conclusion

This chapter has shown that FFIs played an role in China's external liberalization—that is, opening China's domestic financial system to foreign participation—in three different ways: 1) by making normative appeals about the ways in which the opening of China's financial markets would change the thinking of financial sector authorities and financial sector actors in China; 2) by bridging the divide between US and Chinese policymakers on the issue of trade and financial sector liberalization; and 3) by working through institutional coalitions with other industries to push for financial sector opening as part of a broader desire to pursue freer trade with China. These actions

helped to create a consensus at the elite level (between themselves, the US, and Chinese policymakers) as to the extent to which China's Mainland financial services industry should be open to foreign participation.

Important caveats must be made. My aim was not to establish a correlation between lobbying and the outcomes of the eventual terms of China's WTO membership. Rather, what I have outlined above demonstrates that 'lobbying' the US government to open China's financial sector was not a simple process of advocacy on the part of one sector aimed at relevant policymakers. It also involved simultaneous lobbying of Chinese policymakers and forming coalitions with other US-based and international business groups. Representatives of banks and insurers made sure to package the opening of China's banking, insurance, and securities sectors as part of a broader deal to secure the economic opening of China. They pushed against their critics through cross-industry associations to argue that economic openness would lead to better observance of human rights by Chinese authorities, less antagonism on the foreign policy front, and more observance of legal obligations.

From a theoretical standpoint, this chapter has also illustrated how external liberalization in China can be seen as, at least in part, a project of internationalization through elite linkages. That is, those between policymakers in the US, China, and FFIs leveraging their close ties to both. I have defined internationalization as the process of connecting the hitherto closed off Mainland financial sector to the liberalized and globalized financial system by legal and formal means: specifically, those inscribed in the WTO's General Agreement on Trade in (financial) Services. This was done through linkages established between globally situated financial elite and China's policymakers. After experimentation with internationalization in banking and equities throughout the 1990s, financial internationalization—that is, openness to foreign participation—was achieved at the formal, legal level with the conclusion of the agreement on the financial services section of the WTO. In this agreement, FFIs acted as agents that helped to solidify these formalized linkages,

through triangular and issue-based alliances between themselves and the governing elites in China and the U.S.



## **Chapter 3: From external liberalization to systemic barriers: how lobbying victories that led up to China's WTO accession turned out to be hollow.**

### **1.0 Introduction**

On November 10th 2001, the WTO's Ministerial Conference approved China's accession to the organization, and just one-month later China became a full-fledged member of the already extensive global legal infrastructure that governs the movement of goods and services across the borders of its member states. However, the share of foreign banking assets in the financial system remains insignificant—hovering around 2 percent of total assets since implementation of China's WTO commitments (The Economist 2014). Moreover, despite continuing high-level lobbying (at least in the case of US financial institutions) via the U.S.-China Strategic and Economic Dialogue, there appear to be few signs that FFIs are to play a greater role in China's financial services sector. This chapter takes a closer look at FFI lobbying since the conclusion of WTO negotiations between Washington and Beijing and asks: from the point of view of FFIs, given the successful external liberalization of the financial services sector under the WTO agreement, which was in part helped along by FFI lobbying, why have the results of lobbying efforts been so lackluster after 2001? Examining the evidence outlined in this chapter, I argue that while China's WTO accession lifted formal legal barriers to market entry and expansion, FFIs continue to be hampered by a number of systemic obstacles thereto that have little to do with a lack of compliance to the China's commitment to liberalize financial services as specified under its WTO membership agreement. In this way, I illustrate the limits of FFIs' influence over the course of events in China's financial evolution in the reform period.

From the perspective of the foreign banks themselves, direct discriminatory measures comprise an insignificant part of their grievances with respect to entering and expanding in China.

This might constitute a counterintuitive conclusion, since FFIs do not appear to play an important role in the Mainland financial system. But in the context of the argument advanced in this thesis, the findings actually conform to the hypothesis outlined in the introductory chapter. That is, FFIs have played an important role in prompting external liberalization of China's Mainland financial system, but they have done so in a way that actually precludes the need for greater participation by foreign enterprises in the mainland financial system. This chapter will show that China's political economy includes five characteristics that place a ceiling on FFI entry and expansion: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets. These barriers, despite the introduction of WTO-based, formal external liberalization, continue to ensure that FFI influence on external liberalization is limited to transferring technical knowledge and expertise, and helping Chinese state-owned firms raise money in global capital markets. This illustrates that internationalization—in this case, the integration of China's financial system with the world trading system—is not wholly indicative of meaningful liberalization, even when it involves *some* aspects of liberalization.

This chapter will draw heavily on US and European chambers of commerce publicly available annual reports, which the grievances of foreign business in China, focusing specifically on the sections that survey the responses of the financial services industry. After looking at three different lobbying channels available to FFIs in China since 2001, sections 3 and 4 examine FFI lobbying grievances in order to infer some of the ways in which the aforementioned systemic obstacles have limited the role of FFIs in China's Mainland financial sector. Section 5 then looks at some examples of direct FFI to government lobbying and explains the limits of elite-based internationalization. Section 6 concludes by examining the aforementioned systemic obstacles in a global context, proposing that this analysis has applicability beyond the case of China.

## 2.0 Contextualizing FFI lobbying since 2001

As noted in the introduction, the aims of this chapter are rather modest. The goal is not to give a direct account of the central government's policy towards foreign firms. Additionally, the chapter does not make claims about the openness of China's financial sector or the degree of its integration with the global financial system. The evidence offered here only shows how FFIs have lobbied since China's WTO accession, the limits of FFI lobbying, and what FFIs' lobbying behavior can tell us about China's financial system. This section outlines the lobbying channels that have been open to FFIs in Mainland China since the latter's WTO accession agreement allowed the latter to establish on-the-ground business operations there.

FFIs have lobbied in a numbers of ways since they have been allowed to incorporate their business domestically in 2004. An important means of influencing Chinese policymakers has been the individual institution-to-government channel, whereby individual financial firms lobby for access for their own firm, rather than for FFIs as a group—a method employed particularly by some of the world's largest investment banks. This is another example of elite-based internationalization that involves individual FFIs relying on their informal network of personal connections with government connections—typically known as *Guanxi* (关系)—to achieve a piecemeal relaxation of restrictions to their business operations. As chapter 5 will show, this practice has been quite fruitful for the Chinese government and for Chinese state-owned banks, which have been able to acquire foreign financial expertise without ceding ownership rights to foreign institutions in return.

There are a number of interrelated reasons why FFIs have failed to achieve policy influence in this regard despite, as section 5 will show, leveraging not only of *guanxi* in China but the influence of their home governments as well. One major reason commonly given for this is the CCPs' general reluctance to precipitate privatization in the banking sector or a political backlash to foreign ownership in the banking sector (this is addressed in the next chapter). But a small but important variable in this outcome could also be the general lack of collective action on the part of

FFIs in China (Schlichting 2008 makes this point as well). Indeed, a representative of a chamber of commerce based in China noted, FFIs as a group seem to be hampered because too few institutions choose the collective action route as the preferred lobbying option and put too little time and financial resources in collective lobbying (Interview with chamber of commerce representative in Shanghai, July 7<sup>th</sup>, 2014). Despite being largely inconsequential for attaining broadly applicable regulatory changes, this channel remains the most utilized among the three explored in this section.

FFIs also continue to use the bilateral government-to-government channel vis-à-vis United States' bilateral negotiations with China. US Treasury Secretary Henry Paulson in the Bush administration created the US-China Strategic and Economic Dialogue (SED) in 2007 for the purpose of improving bilateral relations between the countries and smoothing out trade and strategic tensions between them. As the next chapter will show, Paulson was an important figure in cementing FFIs' role in China's financial evolution during his tenure as Goldman Sachs' Chief Executive in the mid-1990s through the mid-2000s. Not surprisingly the SED has addressed a number of issues of importance for the US financial services sector, as the chart below illustrates.

**Table 1. Major Documented Lobbying Achievements – US – China SED**

<p>1. “China committed to allow U.S. and other foreign banks incorporated in China to sell mutual funds, obtain licenses to act as mutual fund custodians, and act as Margin Depository Banks in Qualified Foreign Institutional Investor (QFII) futures transactions. Chinese authorities also confirmed that there are no barriers to foreign banks to sell other types of wealth management products to customers or to engage in custodian business with insurance companies.”</p>
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2. “China is now moving to allow foreign banks to underwrite corporate bonds in the interbank bond market. In April, China's corporate bond market oversight body released criteria for underwriters and opened up a one-week period for new applicants, during which time many U.S. and other foreign institutions applied”
3. “China continues to make measured progress in increasing total quotas under the QFII program (which allows foreigners to invest in Chinese stocks and bonds). China's total QFII quota has increased nearly 25 percent in the past year, to \$21 billion”
4. “China committed to deepen the reform of its financial system, including opening new opportunities for U.S. and other foreign financial services firms, to provide more efficient service, control risks, and encourage financial innovation; China committed to move toward market-determined interest rates to better price risk and more efficiently allocate capital in its economy.”

(Compiled and quoted from US Treasury 2011)

In light of the success of utilizing their lobbying channels in Washington throughout China’s WTO negotiations with the US, it is no wonder that this forum continues to address (with some apparent success) some of the outstanding issues that concern (at least American-based) FFIs in China. The incremental regulatory changes that have been achieved in part with the help of the SED also follow Zweig’s (2002) framework of small-scale experimentation leading to broader reform. The utilization of the QFII channel, for example, began as a trial, with portfolio investment quotas allocated to a few select FFIs, and gradually extended to other foreign institutional investors, with more quotas added over time.

The last channel of influence for FFIs in China is cooperative lobbying via the Chambers of Commerce in Beijing and Shanghai, respectively. The data represented in this chapter draws from two of the biggest chambers with an on-the-ground presence in China, the European and

American Chambers. These business associations also include a non-trivial number of FFIs and other businesses headquartered outside of these two jurisdictions, including Japan, Hong Kong, Singapore, Australia, South Africa, Canada, and others. Perhaps counterintuitive to the purpose of this chapter, it should be noted that this is perhaps the least consequential lobbying channel for FFIs in Mainland China.

While the chambers maintain regular contacts with the central government in Beijing and (more significantly) with Shanghai city officials, it is not clear that their concerns are high on the agenda of regulators. Moreover, over the past few years, the Shanghai Municipal Financial Services Office has become increasingly less attentive to their views and has reportedly locked them out of many regular meetings to which they were previously made welcome (Interview with chamber of commerce representative in Shanghai, July 7, 2014).

But the purpose of analyzing the chambers' papers is not to show their impact on policymakers. Rather, the chambers represent the only lobbying channel for FFIs in the mainland that regularly makes the results of the surveys filled out by their members publicly available. As such, it gives us a small but important glimpse into what FFIs are thinking, which grievances they choose to emphasize, and which they choose to de-emphasize. To this end, the anomalies discussed above are actually not particularly surprising. As the next two chapters will show, FFIs' participation in China's financial reforms since the early 1990s has actually contributed to the very systemic obstacles they have faced since China's WTO accession.

Not only have FFIs contributed to the resilience of China's state-owned banks, but they may have also postponed (or prevented) the loosening of China's capital controls. Not only have they helped to keep China's stock markets characterized by an inefficient allocation of capital, but they have also helped to postpone the financialization of China's economy—which in turn maintains the symbiotic relationship between state-owned banks and SOEs.

### 3.0. Methodology

The research that forms the core of this chapter is largely qualitative. I have looked at the lobbying documents issued by two large FFI industry groups located in China—the EU and American Chambers of Commerce. As subsection 2.2 will illustrate, I have categorized the grievances registered in the financial services sections of the annual position/white papers. I have digested the content into clearly readable themes in order to make the opinions of foreign financial institutions more clearly amenable to systematic analysis. I consolidated the grievances (to avoid duplication from executive summaries and sub-section conclusions), weighted them in terms of overall volume of complaints and importance, reduced or increased grievance counts where events or circumstances at particular points in time necessitated weighting, and placed grievances in generalized, simplified categories for visual and conceptual illustration. This helps us to better understand the priorities of foreign financial sector’s lobbying efforts. In areas where the Chamber documents were not sufficiently clear, I have supplemented with field interviews with FFI managers, financial journalists, chambers of commerce representatives, and a foreign diplomat, as well as` and interjections from secondary sources and, in particular, Price Waterhouse Coopers’ annual *Foreign Banks in China* industry surveys, which offer more market-centered surveys of challenges and opportunities for financial firms in China.

#### 3.1. Limitations

To begin, the financial services agreement includes two specific categories of firms: foreign insurance firms, and foreign banking and non-banking financial institutions. However, the analysis in this chapter only concerns the latter. The omission was made for two reasons. First, insurance firms’ grievances were not registered with sufficient consistency in the chambers of commerce papers to include them in my analysis. In some years, their grievances were completely absent from American and European Chambers of Commerce annual reports. Moreover, including

insurance firms would see cost of business and market sophistication grievances over-represented in the data. In some years, insurance firms were separated from the financial services section, and in some years they were included. In those years that they were excluded there're would be particularly large spikes in cost of business complaints because overlapping grievances (i.e. those related to non-insurance financial firms) would be duplicated. There appears to be some uncertainty and lack of clarity on the part of the authors of the annual reports about how to include insurers in the financial services section—if to include them there at all. Moreover, PwC publishes a completely separate set of annual reports titled *Foreign Insurance Firms in China*. While acknowledging that excluding insurers makes for some important inconsistencies in the overall analysis of my thesis (insurers are excluded here but included in chapters 2 and 5) but for the sake of clarity, and more representative data visualization I have decided to exclude them. Besides, including insurers would simply serve to strengthen the point that FFIs have tended to focus their post-WTO group lobbying efforts on cost of business, and market sophistication issues.

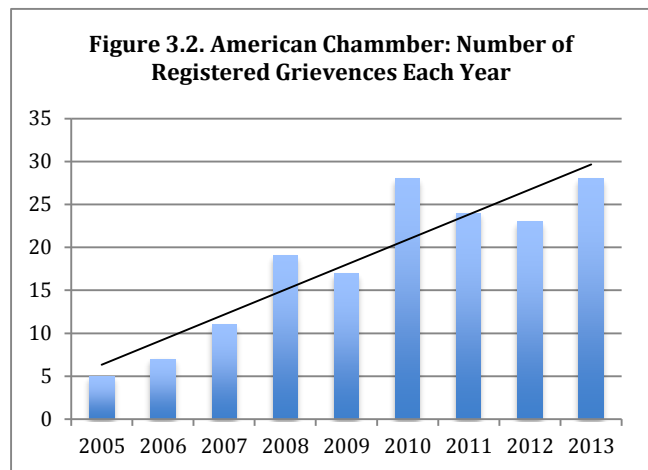
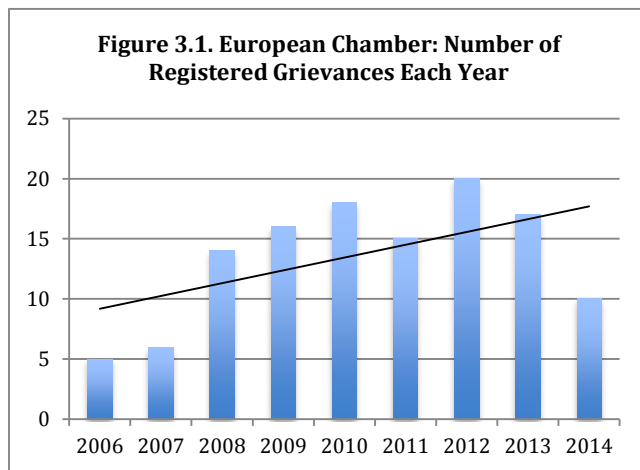
Second, insurance firms, because of the nature of their business, do not raise concerns about the capitalization and liquidity—and important category in my analysis, as I will demonstrate below. Again, while this does not necessarily the inference I make from the data, it does present a challenge of analytical consistency. The category would simply be systematically underrepresented.

There are also other important limitations to my research here. The charts and figures presented here have been drawn from sources that should be seen as publically available lobbying documents and, as such, represent a particular set of views compiled from the annual surveys conducted by the two chambers of commerce in question. The purpose of these documents is public advocacy, not independent survey research. A more carefully constructed source on the views of foreign banks in China is the annual Price Waterhouse Coopers survey of the industry (PwC 2005-2013), which includes not only a more comprehensive and global (i.e. includes more East Asian banks) sample, but a more clearly defined set of survey questions. However, as mentioned above,



these are more market-centered surveys, and include a much less specific discussion of regulatory issues, with much of the discussion outsourced—through citations—to the Chambers themselves.

The limitations of relying on chamber documents alone are compounded by the fact that their comprehensiveness increases in an *almost* linear fashion from 2005 to 2014, as shown in figures 3.1 and 3.2 (not to mention, the number of FFIs operating in China has increased dramatically since then, as more and more have decided to enter and expand in the Mainland Market since the country began to implement its WTO commitments). Therefore, the number of complaints actually rises as regulations are lifted. Messages range from broad calls to open up the financial sector (with imprecise meaning), to specific discussions of policies that members purportedly would like altered.



In some years, lists of existing grievances are replicated (suggesting that the issues remain), while in other years existing grievances are omitted (despite being outstanding). This makes quantitative categories of “openness” too imperfect to be included in this analysis. The limited sample also makes the  $n$  too small to offer reliable quantitative analysis. Therefore, a qualitative analysis of grievances is offered, and cross checked with the aforementioned PwC surveys and supplemented with select field interviews. PwC reports were particularly important in compiling the tables in this paper, as I was not able to obtain EU Chamber Position Papers dating earlier than

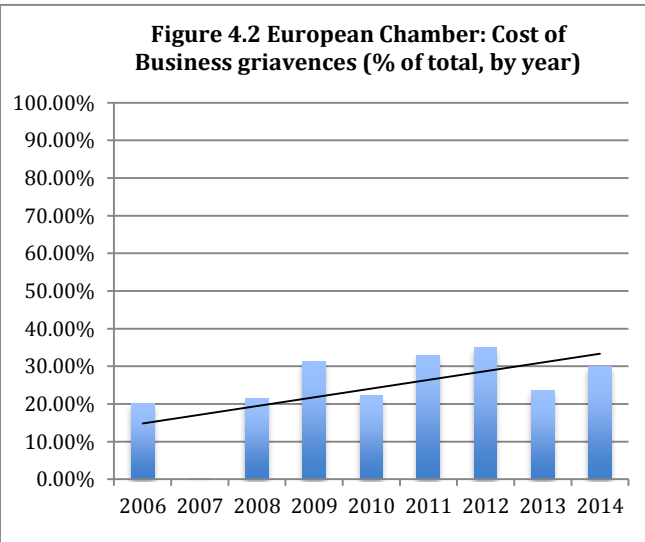
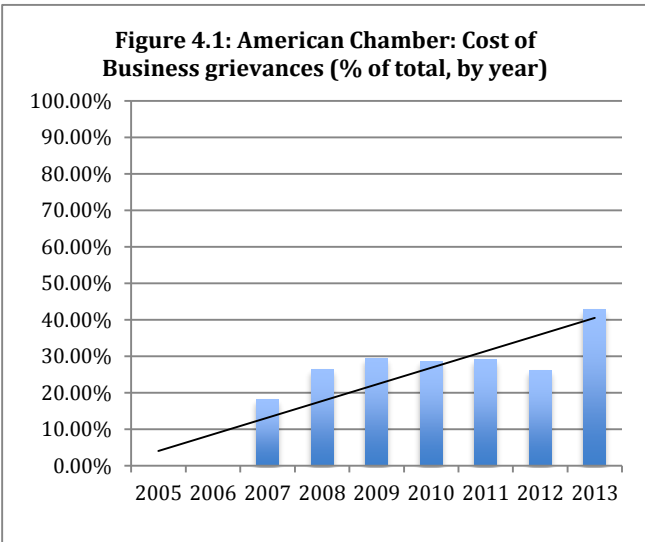
2010. A number of the PwC surveys reprint the recommendations made in the Chamber reports; however, because PwC did not publish a survey in 2006, and because the American chamber has not yet made the 2014 White Paper available to non-members, the time periods for the two chambers do not align perfectly. I therefore copied registered grievances from 2005 to 2006 to address the one-year gap. Interview sources have suggested that 2006 grievances for the EU Position Paper were not significantly different from 2005.

### *3.2. Categories.*

To provide us with useful generalizations and to better understand FFIs' grievances from the surveyed period (2005-2014), I have created 6 categories that fully encompass the types of issues raised by the European and American Chambers of Commerce over the years. The first, *capitalization and liquidity*, includes grievances that discuss the difficulty of bringing capital from abroad to fund foreign invested enterprise businesses in the Mainland—simply put, it refers to anything that relates to China's capital control regime (high capital adequacy requirements were also included here, because capital controls naturally disadvantage FFIs relative to their domestic counterparts, whose head offices are located inland). The second, *cost of business*, refers to anything that would hamper FFI's daily operations (like high taxes) and expansion (vague, onerous, or unclear regulatory requirements). The third, *state intervention* refers to grievances directed at the presence of state-owned financial institutions or the role of the government in allocating capital in the banking sector. The fourth, *ownership limits*, refers to complaints about laws ascribing quantitative limits to FFI equity stakes in domestic Chinese enterprises.

The fifth, *inadequate market depth, sophistication, or poor regulatory framework*, references complains about the inadequate sophistication or poor functioning of Chinese financial or credit markets, or regulators' poor understand of how said markets do and should function. This is by far the most difficult grievance to pin down because in many cases *costs of business issues*

(Figures 4.1 and 4.2) are difficult to separate from this category. For example, complaints about poor regulatory interpretation or coordination on the part of authorities, or long product approval periods, (placed under cost of business issues) are fundamentally indistinguishable from grievances in the fifth category. In many cases, regulators play a game of catch-up as demand for licenses by FFI's test their expertise on regulating foreign entrants, whose managerial structures and risk profiles are very different from their domestic counterparts. As regulators struggle to enforce new rules and ensure the smooth functioning of novel markets and financial products, they naturally lag behind FFI's demands for expansion approvals. As such, I created a sixth category for *cost of business issues related to inadequate regulatory sophistication*. This category duplicates grievances (but does not increase the aggregate count of grievances) so as to make sure that issues belonging in the fifth category are not under-represented. This is especially important in categorizing EU Chamber Position Papers, where the median percentage of registered annual grievances in the fifth category is actually 0 (most of the surveyed years don't include these at all), compared to the US Chamber White Papers, where fifth category issues typically (median count) comprise 25% of total grievances.



#### 4.0 From Legal Barriers to Systemic Obstacles.

Since China's accession to the WTO, the most important limitations to foreign banks' business scope, branch expansion, and liquidity, included: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets. To be sure, these systemic obstacles are constantly evolving in scope and impact. For instance, capital controls are gradually loosening (for example, see Farooq, et al 2015) and financial markets are gradually becoming more efficient (for example, see Studwell 2015). However, as the present analysis will show, their impact on FFI regulatory preferences are far greater than that of regulations that are directly aimed at restricting FFI business scope. This shows that internationalization—the integration of China's financial system with the world trading system—is not wholly indicative of meaningful liberalization, even when it involves *some* aspects of liberalization.

This section will begin by briefly addressing China's WTO compliance in the realm of financial services, and will then discuss what survey data tells us about foreign banks' experiences in China since the WTO implementation period has ended, and place their grievances into context.

Table 2.

<b>Banking</b>	<p>Location: Upon accession, foreign currency business is allowed without geographic restriction. Geographic restrictions on the local currency business of foreign banks will be phased out over five years; four cities will be opened upon accession, followed by four additional cities.</p> <p>Products: Within two years of accession, China will permit foreign banks to provide local currency services to Chinese enterprises; and within five years, to all Chinese.</p> <p>Investment: Within five years of accession, all current non-prudential measures regarding the ownership, operation, and establishment of foreign banks and those concerning their branches and restrictions on issuing licenses, will be eliminated.</p>
<b>Securities</b>	<p>Product: Foreign securities companies may engage directly in B-share business.</p>
	<p>Investment: Within three years of accession, foreign investment banks will be permitted to establish joint ventures, with foreign ownership not exceeding 33 percent, to engage (without Chinese intermediary) in underwriting domestic shares (A-shares) and underwriting and trading in foreign currency denominated securities (B- and H-shares, government and corporate debts).</p>
	<p>Representative offices of foreign securities companies may become special members of Chinese stock exchanges.</p>
<b>Fund Management</b>	<p>Investment: Upon accession, the establishment of joint venture fund management companies will be permitted, with foreign ownership not exceeding 33 percent, to conduct domestic fund management business. Foreign investment shall be increased to 49 percent after three years.</p>
<b>Insurance</b>	<p>Location: All geographic restrictions will be lifted in three years after the entry.</p>
	<p>Product: Upon accession, foreign life insurers will be permitted to provide individual (non-group) life insurance services. Two years after entry, they will be permitted to provide health, group and pension insurance, and annuities to Chinese and foreign customers. Reinsurance is completely open with no restrictions upon accession.</p>
	<p>Investment: Upon accession, foreign life insurers will be allowed to hold 50 percent ownership in joint ventures. They may choose their own joint venture partners. For non-life, China will allow branching or 51 percent foreign ownership upon accession and wholly owned subsidiaries in two years after the entry (i.e., no restriction on the form of enterprise establishment). Licenses will be granted solely on the basis of prudential criteria with no economic needs test or quantitative limits on the number of licenses granted.</p>
<p>Source: Li 2013, p. 84.</p>	

#### *4.1 WTO Compliance*

The financial services section of the General Agreement on Trade in Services (GATS) in the WTO agreement that China signed was a major achievement for FFIs. As Table 2 shows, aside from foreign ownership limitations in the securities sector (specifically, foreign firms participating directly in China's foreign currency, B-Share, markets), many formal barriers to FFIs' right to conduct domestic currency (RMB) business were removed. Indeed, foreign banks were granted 'national treatment'<sup>21</sup> in several areas of financial services—that is, after an implementation period that ranges from one to 5 years, depending on the commitment—and could, at least in principle, have the same rights as domestic institutions after incorporating as local corporate entities. The 2001 agreement, at least in principle, signaled a big breakthrough for foreign firms that have long awaited a clarification of their business scope and predictability with respect to investment risk. As Zweig (2002) has shown, the WTO agreement reached by Chinese and US negotiators removed many of the formal and informal barriers to direct competition between Chinese and foreign firms; it changed the nature of the game, as foreign investment was no longer completely at the best of unpredictable political battles fought at the central government and no longer depended on the discretion of local governments. Simply put, China's hitherto experimentation with foreign investment went nation-wide.

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<sup>21</sup> It should be noted that the WTO does not guarantee national treatment to foreign businesses by virtue of membership. China, however, committed to something approaching national treatment in many areas of banking and finance. See Table 1 for an outline of commitments that China made in its negotiations with the US on its WTO membership.

Needless to say, we should not interpret the agreement itself as implying openness. However, Harpaz (2013) shows that China's compliance record on financial services leaves little to be criticized. Aside from the issue of electronic payments systems (which Chinese representatives argue belong under the category of state monopoly rights, which are not forbidden by the WTO articles of agreement), China has implemented its commitments in a timely fashion. But complying with the WTO is only part of the story. As noted in Schlichting (2008) and Harpaz (2013) the financial services section of the WTO agreement, while not unimportant, is only a framework for openness and should not be interpreted as the end of major struggle on the part of FFIs to carve out market share. As a recent Price Waterhouse Coopers annual report shows (See PWC 2012), regulatory issues consistently stand out as the most important concern for foreign players. And while some years saw staffing and market-related issues in first place, regulatory concerns typically take first place.

How, then, should we appraise the WTO agreement in the grade scheme of Chinese financial liberalization? In Harpaz' (2013, p. 3) words, we should

...lower our expectations – not regarding compliance, but [regarding] what WTO banking compliance can achieve. Compliance cannot achieve full banking reform given the limitations of the rules themselves as well as the state-controlled nature of China's banking sector. For one, as recently noted by the WTO Secretariat, the liberalization of trade in financial services should not be confused with financial opening (usually understood as capital account convertibility) or financial liberalization (usually understood as interest rate deregulation or capital market deregulation) (WTO 2011c: para. 78). Second, liberalization, a fundamental WTO tenet, is not equivalent to privatization. The WTO does not mandate privatization for WTO members nor did it for China. In addition, the General Agreement on Trade in

Services (GATS) permits countries to build legal limitations on market access and national treatment into their commitment schedules.

As such, the WTO agreement signed by the PRC at the end of 2001 guaranteed neither full market opening for foreign companies, nor did it forbid state-ownership of economic resources. But the agreement did create a legal framework for financial services sector opening that FFIs have been eyeing since Chinese regulators began allow foreign commercial banks to conduct some business in China in the early 1990s. But did this framework live up to FFI expectations? The following analysis show that the WTO framework has, at least from the point of view of the FFIs themselves, been quite successful at removing direct discriminatory measures against foreign actors in the financial sector. However, it also shows that many issues of “fair treatment” are difficult to separate from broader issues of privatization, market sophistication, and capital controls.

#### *4.2. What do FFIs complain about?*

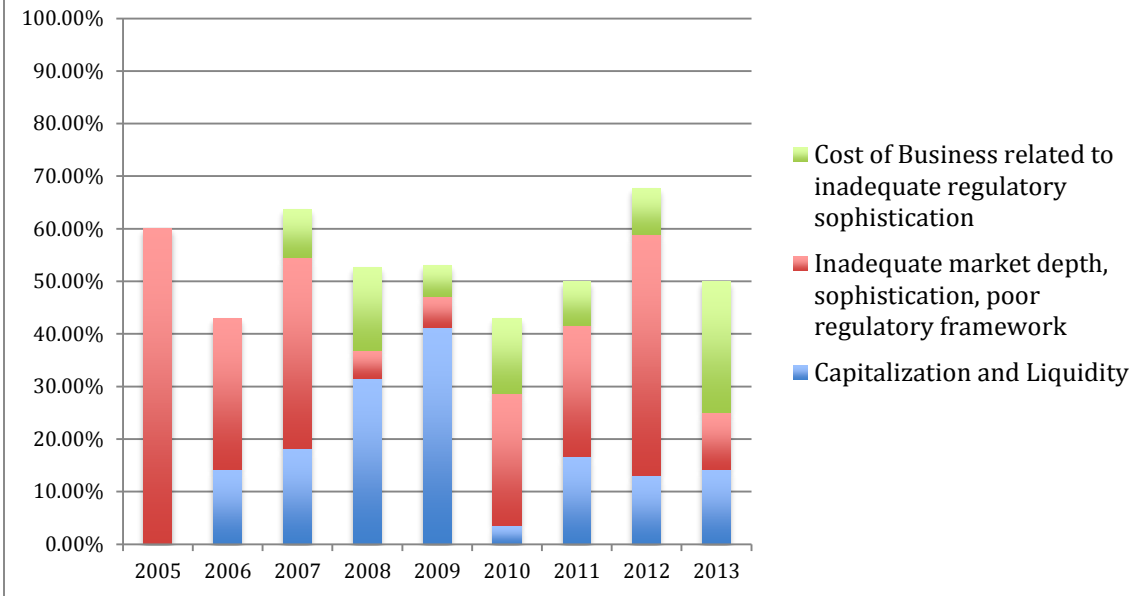
As noted in the introduction, FFI’s role in China’s financial sector has been limited by the following 5 systemic obstacles: 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets. This subsection will explore the ways in which FFI lobbying grievances illuminate these limitations.

This section examines three of most frequently registered grievances by financial institution members of the European and American Chambers: capital controls, issues related to what FFIs see as inadequacies in the sophistication of China’s markets or regulatory frameworks (or even inadequate sophistication of the regulators themselves), and cost of business-related regulatory concerns. As figures 5.1 and 5.2 show, nearly half or more than half of the regulatory issues facing foreign banks can be boiled down to capital controls, market-sophistication issues,

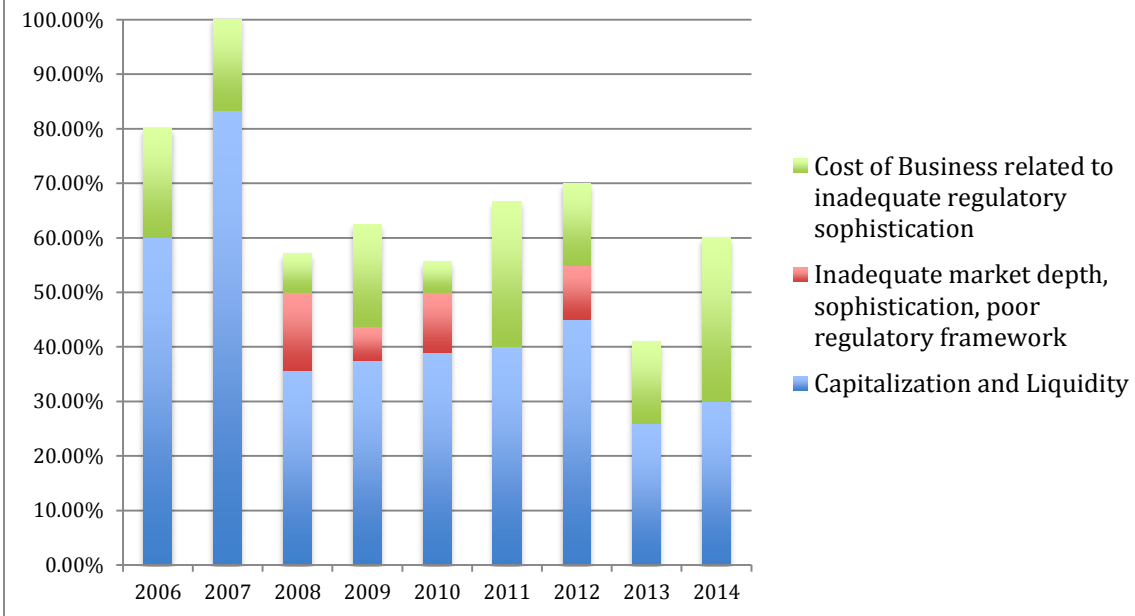


and cost-of-business issues related to lack of regulator expertise and poorly developed markets. This observation is important because it indicates two important underlying issues not only for FFIs in China, but also for our broader understanding of financial liberalization and market opening: that the biggest obstacles, from the perspective of foreign financial actors in China, are China's capital account regime and, to put it rather crudely, the underdevelopment of financial markets in China. Some have come to call this 'financial repression.' One way to conceptualize this term is to juxtapose it with financialization. Simply put, it refers to the repression of the disintermediation of wealth by means of subsidizing bank lending through interest rate ceilings, which force households to save so much that banks become flush with deposits and can lend to corporate clients at very favourable rates, lowering the costs of intermediation and suppressing the rise of non-bank financing as a result (see Vermeiren and Dierckx 2012 for a detailed discussion).

**Figure 5.1: American Chamber Grievances (% of total, by year)**



**Figure 5.2: European Chamber Grievances (% of total, by year)**



Foreign actors are disadvantaged, quite naturally, because 1) they cannot bring enough money from their head offices (or from their regional head offices in Hong Kong)—or to bring it in fast enough—to operate on a fully competitive basis with domestic institutions; and 2) because Chinese regulators and laws are not fully prepared to cope with the complexity of derivative products, electronic banking, and non-credit based banking in general. For example, a 2005 American Chamber White Paper complained that, “China still lacks a functioning bankruptcy system [...] and creditor rights are weak,” and a 2010 White Paper emphasized, “China does not have a uniform commercial code that allows a nationwide collateral registration system codifying the classification and tracking of assets across different geographic areas” (American Chamber 2005). These may seem like mundane legal and regulatory issues, but they effectively bar foreign banks from competing directly with domestic banks in many areas, as the former’s risk tolerance levels do not allow them to engage in higher-risk business with poorly enforced bankruptcy laws and inadequate asset registration systems in place. This is, in effect, obstacle number 1 (a regulatory framework that favors incumbent banks). Similarly, Chamber documents, both European and American, raise issues related to foreign debt quotas, and capital adequacy requirements, both of which are parts of China’s restricted capital account regime (see Vermeiren and Dierckx 2012).

Because the State Administration of Foreign Exchange (SAFE) uses quantitative limits to restrict how much foreign currency locally incorporated banks (foreign and domestic) can borrow or transfer from abroad, foreign banks effectively have less working capital than domestic banks. Additionally, foreign banks cannot easily access the massive volume of deposits that comprise a large chunk of the liabilities in the Chinese financial system, lacking the existing branch networks carved out by their domestic counterparts prior to local treatment being granted to FFIs.<sup>22</sup> As such, their financing needs are much greater than those of domestic banks. Both of these issues pose a

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<sup>22</sup> The poor quality of equity markets in the Mainland, coupled with dysfunctional and nascent nature of bond markets in China, makes deposits take up a disproportionately large part of banks’ liabilities. For a closer look at the structure of banking and finance in China, see, for example, Chang and Lochele (2011).

conundrum for foreign institutions that is not captured well by discussions—often found in financial media—about their low share of financial assets in China. This is, in effect, obstacle number 3 (the persistence of capital controls).

Annual reports published by Price Waterhouse Coopers paint a similar picture with respect to the challenges faced by foreign financial firms in China (PWC's 2012 *Foreign Banks in China* report summarizes half a decade of surveys on the most and least difficult aspects of conducting business in China's financial sector). Regulatory issues, as indicated above, typically land in first place. These are broadly similar to my *cost of business* category but is broader, and include capital adequacy requirements (i.e. capital controls). Foreign ownership restrictions, PWC surveys also registered this category as being of lesser concern for FFIs (in two of the survey years, its importance was actually declining in survey responses—some explanations are offered in section 5.0). The chart also shows a few important elements of FFIs' business in China that are not captured by the Chambers' of commerce reports: notably, the significance of market factors like finding staff, which is almost on par with regulatory issues in the surveyed years. Similarly, product/service offerings and revenue diversification posed big obstacles for foreign firms. These issues are in large part related to the lack of diversification of China's financial markets, and the dominant position interest rate margins as a source of revenue in the Chinese financial system (i.e. financial repression). These issues are all categorized under *inadequate market sophistication* in my categories. Under this regulatory framework, incumbent banks, with their ties to domestic SOEs and large private enterprises, have a competitive advantage. This is a result of obstacle number 5 (the underdevelopment of domestic equity markets).

To be sure, the foregoing analysis does not suggest that China's complex regulatory maze does not pose an immense challenge for FFIs. Certainly, strict licensing requirements, product and branch expansion approval times, taxation, and regulators' slow receptiveness to the introduction of new products all disproportionately affect the profitability of foreign actors relative to domestic ones. Indeed, as figures 3.1 and 3.2 show, these cost of business-related regulatory issues have

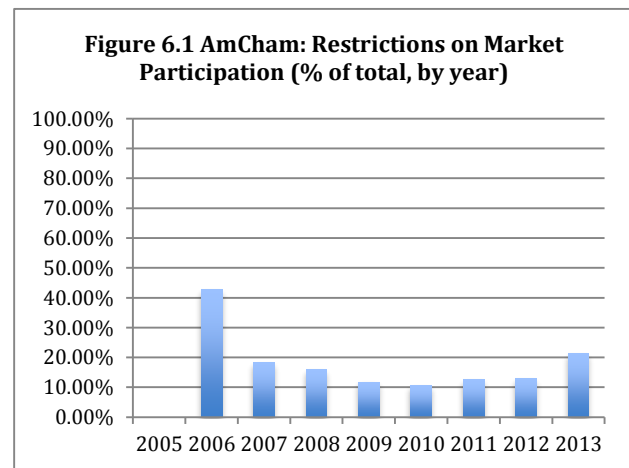
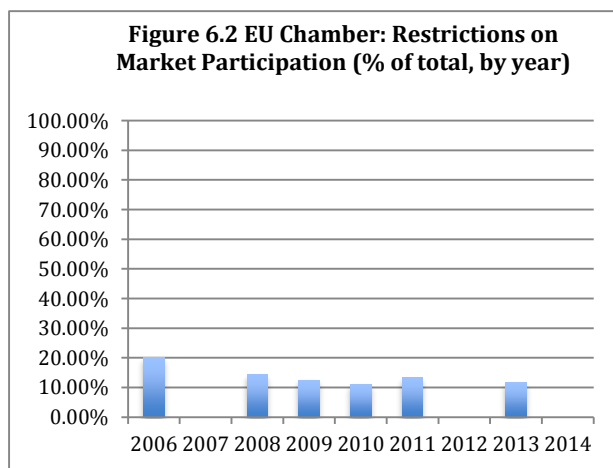
become progressively more important for foreign banks over the years.<sup>23</sup> Likewise, Oliver Wyman (2012) has shown that foreign banks tend to excel in areas where the regulatory requirements are the least stringent, notably wealth management. However, as Oliver Wyman (2012) notes, and as virtually all FFI interviews surveyed here have confirmed, foreign financial expertise also plays a decisive role in many of the “niche” markets (like wealth management and asset management) where foreign banks have captured and hold outsized market share. Moreover, stringent licensing requirements are not reserved for FFIs alone. Domestic institutions can, however, cope with them better because of their less complex business models (foreign banks, tend to rely on more diversified revenue streams, and employ financial instruments not yet approved by regulatory authorities in China), and their more extensive experience in communicating with regulators (Interview with FFI manager, March 19 2013; Interview with FFI manager, May 16 2013).

It should also be noted that registered grievances that fall under the *cost of business*-related regulatory hurdles (long wait times for operating licenses and branch expansion, for example) have actually increased over the years (see trend lines in figures 3.1 and 3.2). One important aspect of such policies is China’s Western Development framework (西部大开发) put in motion via a State Council-level Small Leading Group (领导小组) mandated by Premier Zhu Rongji. The policy framework is multi-faceted and includes a number of economic development areas. However, an important aspect of the plan is, of course, the flow of credit to Western provinces to finance regional development (Lu and Deng 2011). As such, it is much easier for FFIs to gain approval for branch expansion into Western provinces—that is, places where they (with the exception of HSBC) have few potential customers, poor staffing prospects, and little interest in expanding their operations (PwC 2012)—than into Eastern Provinces, where their head offices look to for expanding their China footprint. This creates long wait times for Branch office approval and approvals in locations other than those that were sought.

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<sup>23</sup> This point is addressed in more detail in section 6.

Moreover, it would be quite erroneous to suggest that rising cost of business regulations are the result of more strenuous regulations, as wait times for regulatory approvals and issues of regulatory opacity have actually declined, as PWC surveys (PWC 2012, 2013) have recently noted, and as my interviewees have unanimously suggested. The increase more likely points to the growing sophistication of China’s financial system and its regulatory regime—hence, the number and specificity of complaints. On the whole, these barriers are not directly related to WTO-based formal external liberalization, narrow as it may have turned out to be. Costs of business issues are systemic. The country’s financial system is still defined by state owned banks and policy, or quasi policy-based lending (Gruin 2014), which ultimately favours incumbent banks, and shuts out new entrants (foreign or private) from increasing their market share. As such, being private, not state-owned, enterprises FFIs must compete for licenses and branch permits with powerful government-owned financial entities, and with local and central government preferences for allocating capital to particular regions and cities—not those where FFIs would like to open offices and branches (PwC 2013). This is, effectively, obstacles number 2 and 4 (respectively: the dominance of bank-based lending; close-knit relationships between large SOEs and large banks).



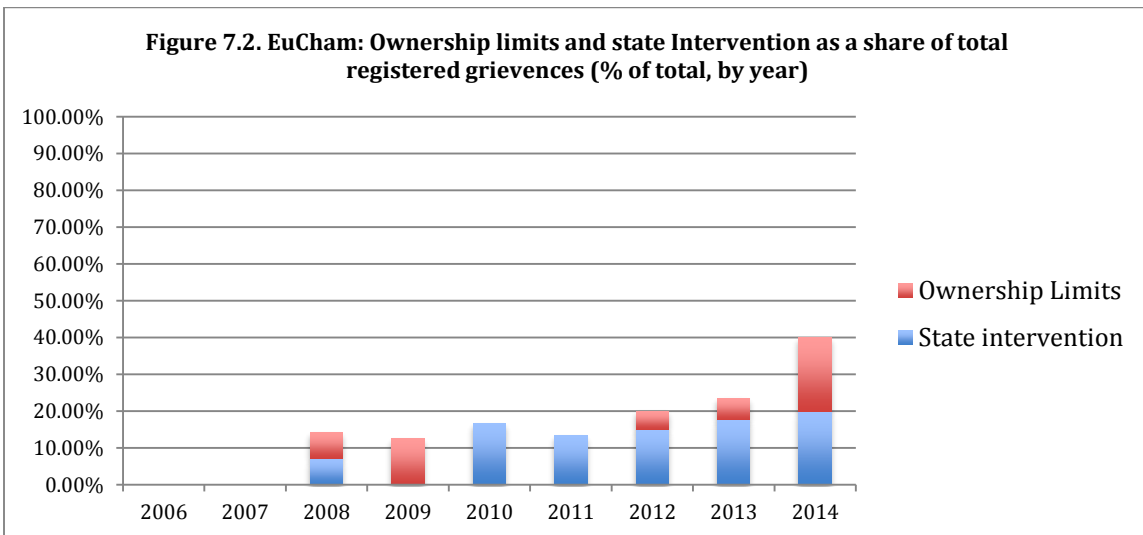
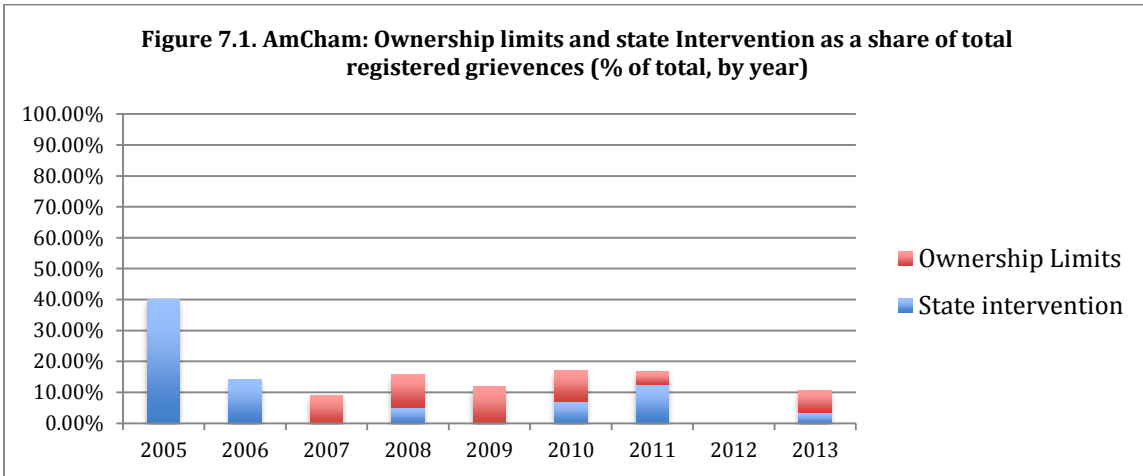
Notwithstanding these difficulties, in 2012 PWC survey respondents surprisingly noted that regulators have gone above and beyond in their receptiveness to foreign banks and even cited

the CBRC as a “more supportive regulator than regulators that the foreign banks have experienced in their home markets” (PWC 2012, p. 6). Moreover, following this marked improvement in dialogue with FFIs, at the start of 2015 China would ease many capital and licensing restrictions (Zhu and Li 2014), in line the CCP’s broader program of gradual capital account liberalization. This is, however, not to say that discriminatory regulatory measures (or, *restrictions on market participation*, in my categories) are of absolutely no concern for foreign banks. As figures 6.1 and 6.2 suggest, most years register at least some grievances that list instances where Chinese authorities put restrictions on FFIs that they do not apply to domestic banks. However, a vast majority of grievances registered under this section concern China’s long disputed policy of maintaining a state monopoly on electronic payment systems—the Unionpay monopoly—or restrictions on foreign participation in the securities sector.

With respect to market barriers in the post-WTO era, it is clear that FFIs do not see laws that restrict foreign participation in China’s financial system to be nearly as significant as capital controls and inadequate market and regulatory sophistication. These findings suggest that it is possible for China to remove *direct* discriminatory barriers to foreign capital, without changing the significance of foreign capital in its domestic financial system. As long as the degree of bank-based intermediation remains high, state-ownership remains dominant, and capital controls remain in place, direct discriminatory barriers to foreign entry remain relatively inconsequential for containing the expansion of foreign capital inside the Mainland financial system.<sup>24</sup> My findings also suggest that capital can leave peacefully side-by-side with state-owned capital in the financial system. Direct state-interference in the allocation of capital register as relatively minor grievances compared to the others surveyed here, as figures 7.1 and 7.2 illustrate. This is not to say that FFIs would not be elated by further privatization or the reduction of outsized state ownership/interference in the financial sector.

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<sup>24</sup> However, I’m not suggesting that this is the actual logic or intent of China’s policymakers. I am deducing FFI preferences, not policymaker preferences.



This presents us with a rather puzzling picture. Why do FFIs appear to care so little about participating in China’s securities and commercial banking sectors? This observation of the grievances registered in the chambers of commerce annual reports is a very counter-intuitive one, because owning a larger share of China’s banking sector and investing more capital in its stock markets would arguably benefit FFIs quite substantially. The next two subsections take a look at this anomaly in more detail.



### 4.3 Limitations on Foreign Ownership

Many countries, developing and developed, regulate and limit foreign takeovers of ‘strategic’ industries, and China is no exception in this regard. In the case of banking, Chinese law prohibits any one foreign shareholder from controlling more than 20% of a Chinese bank, and in the case of securities firms, only joint ventures are permitted, with foreign partners barred from taking a stake larger than 49 percent. However, it would be a conceptual error to reduce these restrictions to a simple case of discriminatory treatment against foreign firms. Curiously, as mentioned above, and as figures 5.1, 5.2 suggest, foreign firms do not seem very much bothered by these restrictions.

An important issue at play here is privatization of China’s public companies, as most of China’s large financial institutions are publically owned. While China’s privatization in the economy as a whole has been quite substantial (Steinfeld 2010), many industries—such as finance—maintain a large state presence (Lardy 2014). While many of China’s state-owned corporations have listed in New York, Hong, Kong, London, and other financial centers, a vast majority of them remain effectively state-owned, with government shares often entirely unlisted (Liu and Pei 2005); additionally, ‘strategic’ institutional investors, which sometimes own as much as 20 percent of China’s large banks, often do not have any effective management levers. One FFI manager (who is also involved with the management of one of the Chambers) suggested ownership restrictions do not feature prominently in Chamber documents partly because they are very similar in scope to the broader issue of the state’s role in the allocation of capital (Interview with FFI Manager, May 16, 2014). This of course, is another way of referring to obstacle number 4, the close-knit relationships between large SOEs and large banks.

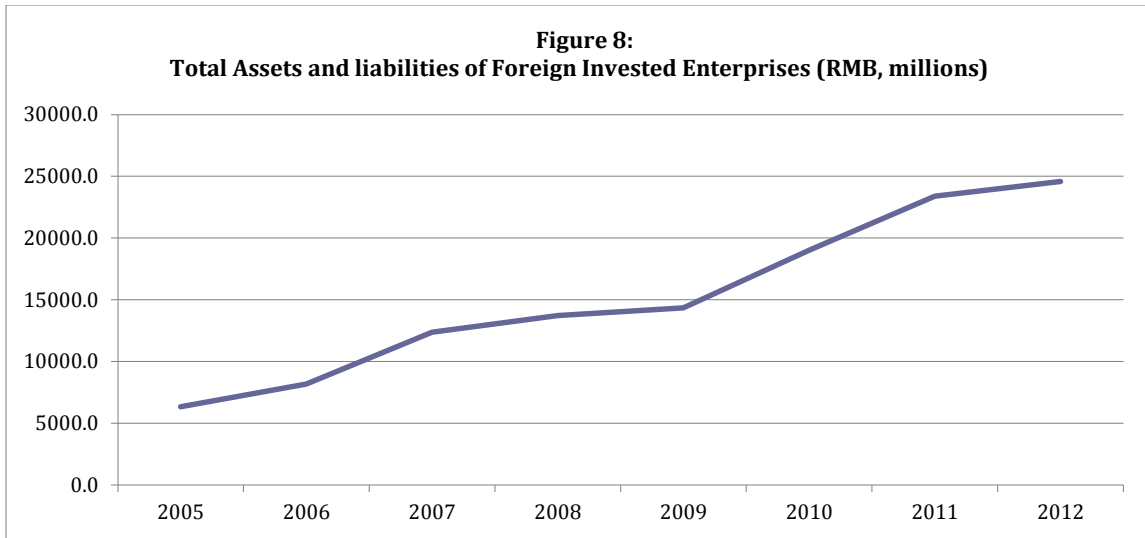
Additionally, we need to be cognizant of the Chinese government’s broader approach to foreign capital, versus its approach domestic *private* capital—especially in the financial sector. While the growth of shadow banking has shepherded rapid growth in private capital in the financial system (Tao and Deng 2013; Studwell 2015), this has happened in spite of regulatory oversight,

rather than as a result of a deliberate policy. By contrast, FFIs have received much more support from regulators and lawmakers than their domestic, private sector counterparts, which often operate in what are effectively black markets (see, for example, Tsai 2004a). And while in principle, FFIs comprise privately owned capital, they are in many cases offered better legal protection and have less market entry barriers than their non-state-owned counterparts. Gallagher (2011), for example, has shown not only that foreign capital has been used strategically by the CCP to capitalize and revitalize the state-owned sector, but also that private capital has actually had a harder time than its foreign counterparts in getting a foothold in China's export sector than its foreign counterparts.<sup>25</sup> Certainly, the level of foreign ownership of financial assets (which has only very briefly breached the two percent mark) is very low.

But simply focusing on financial institution ownership misses the point. Assets of foreign invested enterprises in the financial sector have grown almost five-fold since the tail end of the GATS financial services phase-in period, hampered only by the US credit-crunch in 2007 and the resulting financial crisis of 2008-2009 (see Figure 8 for illustration). On a compounded basis, FFIs's asset growth ratio has been 19 percent, and their profits have grown at a rate of 26 percent between 2001 and 2011 (Wang 2012). If we adjust these calculations for the period surveyed here (2005-2014), these numbers are sure to be higher. In other words, foreign-owned assets in the Mainland banking and non-banking financial system have proliferated very rapidly since WTO accession, just *not nearly as rapidly* as those of their state-owned counterparts.

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<sup>25</sup> China's export sector has been disproportionately outsourced to multinational businesses. See, for example, Hart-Landsberg 2011 and Athukorala and Yamashita 2009 for a discussion on the role of foreign capital and FDI in China's export sector.



Source: China National Bureau of Statistics

There is also little evidence that Chinese authorities have deliberately sought to keep foreign banks out of China’s financial markets or to undermine their WTO commitments to open their domestic financial services markets to foreign participation. Two of the three regulators responsible for governing financial assets—the PBoC and the CBRC—have actually expressed concern that foreign banks control too few assets in the financial system. The CBRC is, likewise, not known to be an opponent to foreign bank entry and greater participation in China’s banking sector. In fact, it has explicitly expressed its desire to see foreign banks’ assets rise to 5 percent of total mainland banking assets (China Banking Regulatory Commission 2008). A manager of a foreign bank that boasts a significant part of its revenue from its Mainland China business has noted that generally speaking, regulatory authorities—especially the PBoC and the CBRC—actually encourage foreign banks to lend more (especially to small and medium-sized Chinese firms) and to open more branches, which actually sometimes conflicts with foreign banks’ own risk tolerance levels (Interview with FFI manager, March 19 2013).

#### 4.4 *The Securities Sector*

This sub-section illustrates that many aspects of FFI grievances regarding China's regulatory system boil down to this group of actors' dissatisfaction with China's capital control regime. This further emphasizes the point that bringing down barriers to FDI, as one aspect of external liberalization, does not necessarily leave foreign businesses with a level playing field in every sector—certainly not so in the case of the financial sector. This is another example of how internationalization—in this case, the integration of China's financial system with the world trading system—is not wholly indicative of meaningful liberalization, even when it involves *some* aspects of liberalization.

Between 2005 and 2008, the American Chamber of Commerce (less so the European Chamber, curiously) complained various times about discriminatory treatment in the area of securities trading and underwriting (albeit, as discussed above, the proportion of complaints that comprise direct discriminatory treatment was low even during those years). This is not entirely surprising even in the context of the argument given here. As Schlichting (2008) notes, the securities sector was the most closed among the different categories of financial services, and remained the most 'closed' following WTO accession. Foreign participation in the securities sector remained tightly controlled and went well beyond merely inconveniencing foreign firms with long RMB license wait-times and long and confusing approval processes. Foreign investors were only allowed to trade shares on China's stock exchanges, and other direct financing business in the form of joint venture (JV) partnerships, and never allowed to exceed majority share therein. Foreign investors looking to participate in business in domestic securities investment fund management were granted the right to take a 33 percent stake in Sino-foreign JV partnerships immediately following WTO accession, and promised to increase their stakes to 49 percent, following a three-

year phase-in period (Bhattasali 2004). Underwriting was initially limited to a 33 percent maximum stake for the foreign participant in a Sino-foreign JV (WTO 2002), but share was raised to 49 percent at the 2012 US and China Strategic and Economic Dialogue (SED).

However, much like the case of ownership restrictions in banking, the actual proportion of discrimination-related grievances (controlling for the variable of capital controls), at least from the perspective of foreign firms, is quite small. This is likely because many FFI grievances have been addressed via the SED (US Treasury 2011; see above) and through direct contacts between individual FFIs and Chinese policymakers (Interview with former FFI manager by phone July 11 2013). But more importantly, many of these issues are fundamentally related to China's capital control regime, and cannot be simply reduced to direct discrimination against FFIs. While FFIs have long tried to lobby the Chinese government for greater access to China's mainland equities market, this lobbying needs to be viewed within the broader narrative of securities sector reform. Following the linkages created by FFI lobbying for China's WTO accession and their work with the central government, directly, to reform the banking sector, official, formal channels have been established to give FFIs input into China's policymaking process. The SED is one of such channels. But other similar channels exist, such as the CBRC's Council of International Advisors—an external advisory board comprised of FFI managers, who provide guidance and advise to the agency on policy and daily regulatory matters (China Banking Regulatory Commission 2015).

China's policymakers have long experimented with giving foreign banks more access to China's securities markets. A select group of foreign banks were granted controlled access to China's equity markets in 2003, through China's Qualified Foreign Institutional Investor Program (QFII), which was instituted the prior year. Quotas under this scheme have been significantly increased over the years, albeit remain a small part of the overall market. Why, then, did Chinese authorities choose to limit FFI access to the domestic A-share market? More pertinently, why does this issue stand out for mapping out FFI preferences in China's financial sector reform? Quite simply, the narrative of China's securities markets reform demonstrates the extent to which

restrictions on FFIs in this area are also inseparable from China's restrictions on the movement of capital across its borders.

The story dates back to the 1997-1998 Asian Financial Crisis, which had changed the central government's outlook on what the financial system ought to look like (Wang 1999) and prompted the bureaucratic apparatus to restructure accordingly (Heilmann 2005a). Following the crisis, a plan that was eventually implemented, spearheaded by then premier Zhu Rongji, sought to improve efficiency in the nearly bankrupt banking sector by changing the managerial incentives and business models of Chinese state-owned banks. An important part of this plan involved listing a minority of state-owned banks' shares on stock exchanges in Hong Kong and New York in order to expose state-owned banks to global capital markets and thereby improve efficiency. At least some studies indicate that this scheme was successful (McGuinness and Keasey 2010; albeit, some would disagree on whether there has been much real improvement; see Shih 2008). Inadvertently, this would mirror a later proposal for addressing the woes of China's malfunctioning domestic stock markets.

Following WTO accession, Beijing sought to clearly delineate responsibility between the CBRC, the PBoC, and the CSRC in regulating the country's financial system. The CBRC would take over banking regulation, the PBoC would be the financial stability watchdog, and the CSRC would regulate securities. As in most countries, the interconnectedness of the various areas of the financial services sector brought with it the malaise of regulatory turf wars. At around this time, a debate sprang up between the latter two bodies—as financial stability and securities trading become more and more intertwined—in how to resuscitate the then moribund Shanghai and Shenzhen exchanges, which increasingly functioned like casinos, with little in the way of value trading. Additionally, they had to decide on what to do about a number of insolvent securities trading firms that increasingly posed a systemic threat (cue the PBoC), which became a notable possibility circa 2004, when the CSRC placed a moratorium on all new offerings in the mainland. The warring CSRC and PBoC failed to come to an agreement about the most appropriate solution, but the former

eventually won out on the question on what to do about China's non-tradable shares, that until 2005 comprised a large part of China's A-share markets. In contrast to the PBOC's proposed solution of relaxing capital controls and letting foreign money purchase some of these shares, the CSRC's plan of compensating owners of non-tradable shares (domestic securities companies) was eventually adopted (Walter and Howie 2009).

The American Chamber inserted itself into this debate in 2006 and 2007, when it actively made a case for allowing foreign firms to play a bigger role in purchasing ailing financial firms, in order to fix the Chinese securities sector from the inside, by offering the highest industry standards for risk assessment and managerial expertise:

Foreign banks need the ability to own controlling interests in local brokerages, leading to fully licensed operations. Though provisions for foreign-invested joint venture enterprises exist, foreign participants in such arrangements remain prohibited from majority share control and market A-share trading. Lack of brokerage capabilities handicaps equity underwriting and limits the ability of foreign players to manage earnings volatility. In addition, restrictions on foreign participation prevent foreign companies from sharing best practices and expertise with local institutions. In the end, these restrictions hurt both the foreign players and the domestic firms (American Chamber 2006, p. 92)

The PBoC was on board (Walter and Howie 2012)—in fact, this echoed its earlier plan of letting foreign institutional investors address inefficiencies in the Shanghai and Shenzhen exchanges—and eventually central governments in both the US and China were in direct talks about how this might be achieved. In a 2007 speech in Beijing on March 7th, then Treasury Secretary, and former Goldman Sachs Chief Executive Henry Paulson, gave an outline of how Chinese policymakers ought to reform their financial system, which stressed the necessity of letting foreign banks play a

greater role in China's financial markets, with said managerial and risk assessment expertise solving the fundamental structural problems of China's persistently dysfunctional financial markets. Paulson quoted Premier Wen Jiabao, who at the time pushed for "Opening up the financial sector wider to foreign financial help, and introducing advanced foreign management experience, technology, and personnel to accelerate the pace of innovation in China's financial system to improve efficiency and competitiveness" (quoted in US Treasury 2007). This echoed long-standing calls by the Bush administration officials for accelerated financial liberalization in China, with the previous Treasury Secretary, John Snow, making remarks along the same lines as early as 2005, (Cody 2005), and in 2006, when he called for "greater scope to use more market-based policy tools" in China's financial system (US Treasury 2006).

After the 2008 global financial crisis, this issue had also become less prominent in the American Chamber's annual white papers.<sup>26</sup> Indeed, the loss of US legitimacy in the area of finance and the increasing Chinese confidence about their approach to managing financial flows across borders and within their own economy (Schweller and Pu 2011) has effectively taken the steam out of this kind of lobbying. But, to be sure, many of the grievances registered in the annual US Chamber White Papers between 2005 and 2008 were eventually addressed through the SED, as the table 1 in section 2 illustrates. As one interviewee noted, the debates, in China, around securities sector reform were only incidentally about discriminatory treatment. More fundamentally, they were about capital account liberalization (Interview with FFI manager by phone, 23 May 2013), or obstacle number 3.

Allowing foreign financial firms to trade freely in China's A-share markets, as opposed to incrementally raising their QFII quotas, would mean greater integration of China's stock markets

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<sup>26</sup> Curiously, the European FFIs never made the same push to open up China's securities, as their American counterparts. Not only is there little mention of securities sector-based discrimination in the annual Position Papers, but neither the EU nor individual European governments have used the same high-level lobbying channels to push for securities sector access.



with global capital markets. Not surprisingly, the American Chamber's 2008 White Paper was quite explicit in its shift in lobbying strategy, noting that China ought to move beyond

...the minimum market access frameworks laid out in the investment services section of its WTO Accession Agreement... AmCham supports the continued efforts of U.S. Treasury Secretary Paulson, working through the SED, to open up this important sector to U.S. firms. Recent stock market volatility and the high valuation of China's domestic markets illustrate *the problems of restricting the flow of capital and cordoning off China's securities market from global securities markets and international capital flows*. We believe that U.S. firms could therefore play a vital role in promoting stability, governance and market efficiency in China's capital markets [emphasis added] (American Chamber 2008, p.2).

As such, the QFII program remains the default policy, as capital account liberalization proceeds at an only gradual pace. FFIs, meanwhile, remain muted in their calls to have China open its financial markets to greater foreign participation, instead focusing on promoting measures that would internationalize Chinese financial markets further and gradually achieve capital account liberalization.<sup>27</sup>

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<sup>27</sup> One example is the American Chamber's 2012 *Shanghai 2020* report, which culminated in part from the Chamber's consultation with officials from the Shanghai Financial Services office—a special municipal government organ created to promote the growth of its financial services industry (American Chamber 2012b). The report examines the Shanghai municipal government's efforts to make Shanghai a global financial centre, and makes recommendations to Shanghai authorities.

## 5.0 FFI-to-Government Lobbying.

Much of this chapter has looked at how five features of China's political economy—a regulatory framework that favor incumbent banks, the dominance of bank-based lending, the persistence of capital controls, close-knit relationships between large SOEs and large banks, and the underdevelopment of domestic equity market—have impeded FFI market entry in expansion in the Mainland financial market. However, the first of these five obstacles—the bias of China's regulatory structure toward domestic banks—remains to be explored in greater detail. At first glance, this seems like an odd 'systemic' feature, because at first glance it appears more descriptive of a discriminatory measure than an *informal* barrier. In many ways, this feature is quite *formal*, as it includes statutory ownership restrictions. Even though these might be aimed more at preserving state monopoly over the commercial banking sector and might not be aimed at keeping foreigners out per se (Tsai 2004a has shown that private financial enterprises face arguably harsher rules-of-the game), they form formal, legal barriers nonetheless.

But that is precisely the point: internationalization does not preclude restrictions on the extent of financial liberalization. This distinction explains how, even in a post-WTO environment, legally protected market access does not guarantee that FFIs greater ownership over the financial sector—even when many local government officials and the FFIs themselves have a shared in this outcome. The following two case studies demonstrate that despite a number of FFIs' close relations with Chinese officials and collaboration on a number of policy issues—despite their participation in the internationalization of Chinese banking services at the elite level—they were not able to force a change to the rules restricting foreign ownership of Chinese banks.

## 7.2 HSBC's retail banking push

Few foreign financial institutions have built extensive ‘guanxi’<sup>28</sup> networks in China’s financial sector like HSBC, who had taken the lead in its retail ventures in China earlier than almost any other bank (Slater and Soh 2010; Paulson 2015; interview with foreign diplomat in Beijing, 26 September 2012). But HSBC’s China strategy has gone beyond than the now infamous princeling hiring tactics employed by many foreign banks in the Mainland. Instead, HSBC entered China well before its competitors, as early as the late-1970s. Moreover, HSBC—along with Standard Chartered (Chen 2011)—maintained commercial representation in the Mainland even during the Cultural Revolution. Following the start of Reform and Opening Up, HSBC did its utmost to style itself as not simply a foreign bank, but as a Chinese banks, albeit headquartered in Hong Kong (it should be remembered, in lieu of its British colonial origins, that the iconic acronym that presently represents its global brand stands for “Hong Kong and Shanghai Banking Corporation”).

By 2015, the bank has at least 170 branches in China—more than any other foreign bank (HSBC 2015). Moreover, unlike most other FFIs, HSBC is not shy to open branches not only in first-tier cities like Beijing, Shanghai, or Guangzhou, but in second-tier cities like Shenyang and Dalian (Slater and Soh 2010). Known locally as *hui feng* (汇丰), the FFI is popularly perceived to be a Hong Kong bank, or even a local bank specializing in high net-worth client services. As one HSBC banker was noted as saying “There’s a chance for HSBC to slip in early and become almost a semi-domestic bank in China. It’s a foreign bank, make no mistake about that, but they are a long standing friend of China” (quoted in Slater and Soh 2010).

HSBC has been far less shy than other foreign banking institutions in trying to break into China’s lucrative but politically fraught retail banking markets (the other notable examples being

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<sup>28</sup> I rely on Wang’s (2014) definition of the term, which defines it as a social, relational currency with four broad characteristics: utilitarianism (mutual exchange of favours), transferability (social debt as transferable and fungible social currency), and intangibility (the code is unwritten and deliberately opaque).

Societe Generale and Citi Group, which are explored below). They have done this in two ways. First, it has pooled its resources largely into entering the retail banking—rather than investment banking—side of the financial system. As mentioned above, branch expansion has been its goal, with a focus on Wealth Management and providing foreign exchange services to internationally oriented private clients and companies (Slater and Soh 2010). Even when China’s retail banking market was saddled with inestimable non-performing loans and a marked lack of sophistication, HSBC’s executives pooled resources and convinced shareholders to think decades ahead, arguing that less stellar results in the present need to be endured, if only to appease China’s policymakers (Paulson 2015). This is not to say that other banks eschewed guanxi or chose more myopic China strategies, but that HSBC had gone out of its way to cultivate good will to transform its image into that of a Chinese bank with international experience rather than simply a foreign bank with Chinese Roots (Slater and Soh 2010).

This was the logic behind the second part of their approach to China’s retail markets: making strategic investments not only to profit from them, but to ultimately cultivate enough good guanxi to the rules of the game in their favour. In 2003 HSBC made an unprecedented move—Paulson has gone so far as to say that they had “gone out on a limb” (2015, p. 158)—to buy a 19.9 percent share of the Bank of Communications. At the time, China’s banking system was undergoing restructuring and only just emerging from fundamental insolvency. Goldman, for example, was approached to make strategic investments not only BoComm but in China Construction Bank (CCB) and ICBC as well (Paulson 2015). Paulson said to have declined all but the latter, which he eventually only reluctantly accepted, opting for a lesser share (with Germany’s insurance giant Allianz purchasing 3 percent along with them) at that (Ibid). Fortunately for HSBC, at least for the next few years, this strategy seemed to pay off. Shares of Chinese state-owned banks rose sharply as they were listed, one by one, in Hong Kong and New York. After 2004, other banks struggled to catch up as they scrambled to make strategic investments in what were only two short years earlier insolvent state owned entities.

But ultimately, HSBC failed to achieve its goal of leveraging their good standing with high-ranking members of the CCP to change the institutional environment for FFIs in the retail banking market. While it remains largely unknown the extent to which their *guanxi* networks in commercial banking were superior to those of their competitors, what is known with more certainty is that high level executives in the bank hoped that this would allow them to convince the central government in Beijing to bend on the issue of capping foreign ownership in Chinese banks. In 2008, HSBC was reported to have applied to raise their ‘strategic’ stake in BoComm from 19.9 to 40 percent. Some sources even reported that they reached a tentative deal with BoComm executives to proceed with the share expansion, pending Beijing’s approval (Chen 2011). Simply put, this was a huge deal for foreign banks in China. This would not only break the CCP’s long-standing resistance to capping foreign ownership in state-owned institutions, but would make the banks rival the Shanghai government on BoComm’s board of directors (the government already sold 13 percent of its shares to institutional investors in a \$1.6 IPO in Hong Kong in 2005). In political sensitivity of the deal was palpable. On March 10 2008, the Bank’s Hong Kong Executive Director event went so far as to deny that any such deal was ever made (Dealbook 2008). At the Very least, the 2004 agreement between the two banks to have HSBC buy 19.9 percent of the city-owned institution stipulated that a 40 percent stake was to be considered, if Chinese laws were to change, signaling that the former was interested in playing the long game (Rabinovich and Heng 2009). Nevertheless, no such approval was made in Beijing. While it is fair to say that a number of coalescing factors led to the central government’s decision, it should be noted that HSBC’s strategic stake in BoComm was made prior to the 2008 financial crisis, at a time when financial reform looked to be on linear path towards more openness toward foreign actors.

### *7.3 Citigroup’s Near Miss*

Citigroup might go down in history as the bank that nearly changed the fortunes of foreign commercial banks in China— ‘nearly’ being the operative word. At the turn of the millennium, the Guangdong provincial government found itself in a financial mess so deep that even its status as China’s fastest growing province, and gateway to global economy, would not guarantee it a central government bailout. While the story is certainly long and complicated, beginning as early as 1988 (see Chen 2011 for a detailed account), for the purpose of the present analysis their state-owned investment arm, the Guangdong Development Bank (GDB) had made an exceeding amount of property and industrial SOE loans in Guangdong province that banked on China’s continued, uninterrupted expansion. In 1998, when the East Asian financial crisis hit China’s financial and export sector, it was beginning to look as if many of these loans could not be repaid. Of course, this was little different from the pattern witnessed in much of the rest of China’s financial system (Walter and Howie 2012). However, the GDB case, while not quite as headline-grabbing as an insolvency in the Big Four state banks (insolvent that they were, it was never publicly announced), was more than a little bit significant. In 1999 the province stepped in and assumed direct control over the bank, thus assuming its hitherto unknown plethora of non-performing assets. From 1999 to 2003, as Guangdong authorities probed deeper into the books and client network of the bank’s executives, each investigation uncovered more non-performing loans (NPLs). By 2003 the problem was deemed to be so extensive that neither the Ministry of Finance, the Central Bank, nor one of the Big Four were willing to step in—Guangdong model and leader of Reform and Opening Up was itself facing insolvency (Chen 2011).

Beijing appeared to be sticking unrelentingly to its policy of fiscal decentralization. Guangdong was told forthrightly to resolve its NPL issue on its own. Seeing few domestic lifelines, the authorities had little choice but to turn to foreign investors. In 2003, provincial authorities quietly began to explore attracting a consortium of foreign investors to privatize GDB. At the time, they were not simply seeking a partial privatization. Instead, they were hoping to unload as many of their non-performing assets, so as to take what they saw as a ticking time bomb, off their hands

(Chen 2013). By 2004, just as HSBC, Goldman, Morgan Stanley, Allianz, UBS, Bank of America, and Deutsche Bank, one by one signaled their intention to ‘go long’ on the future of China’s financial system by ‘strategically’ investing in Chinese state-owned financial institutions Citi, much like HSBC, decided to ‘go out on a limb’ and bid to assume GDB’s bad loans in order to acquire its vast network of retail banking branches in the still unprecedentedly fast growing province of Guangdong. Citi’s vision was quite different from HSBC’s long view: they wanted to go all in on creating a Chinese subsidiary with on-the-ground assets; to break open China’s retail banking market by coming to the rescue of the ailing Guangdong province (Chen 2011). Early on, however, other FFIs—namely Singapore’s sovereign wealth fund (the Development Bank of Singapore, or DBS), and France’s Societe Generale were eager to do just the same (Ibid).<sup>29</sup>

DBS dropped out of the race after the first round of bidding for a number of reasons, including a stock market slump in Singapore in 2005.<sup>30</sup> Despite the (still) mounting losses popping up on GDB’s balance sheets, the Guangdong government saw the cards stacked in their favour. Quickly recognizing the potential significance of the GDB privatization to the FFI community in China, they convinced Ping An insurance—a state-owned insurer—to join the bidding war. To be sure, there was no CCP conspiracy at play here: Ping An’s management had for several years sought to carve out a horizontal integration strategy by adding commercial banking to its asset holding portfolio. A more plausible explanation suggests that Guangdong simply played its cards well. In 2005/2006 the fortunes of China’s financial sector were turning. State-owned bank restructuring was working and FFI strategic investments in the former were paying off; the argument that restructuring would work because aggregate growth ameliorate systemic NPL problems seemed to

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<sup>29</sup> Other FFIs, like the UK’s RBS, formed the first group of bidders. However, Societe Generale, City, and DBS quickly came out ahead by outbidding the rest and bringing in additional FFI and Chinese SOE partners on board as consortium members.

<sup>30</sup> The bidding war came a bad time for DBS. As a SWF, they owned a substantial quantity of shares of a number of key companies on the Singapore Stock Exchange. As such, their domestic portfolio suffered enough losses to dissuade them from competing with Citi and Societe. The latter two, still flush with cash from the pre-2007 windfalls in global finance, easily pushed DBS aside.

be winning the day. FFIs were rushing to get a foothold in China as investment barriers were reduced at an unprecedented pace. FFI managers saw a foreign-friendly environment permeating even the highest ranks of the CCP (Paulson 2015; Chen 2011). Moreover, WTO commitments were implemented on schedule and Zhu Rongji's promises of prosperity from sharp trade and financial openness seemed to be paying off (Walter and Howie 2012). Even Chinese state media began to speculate on the prospect of the central government lifting their 25 percent cap on foreign investment in Chinese banks (People's Daily 2005)

Sure enough, Guangdong's patience paid off. Societe Generale pitched its hands off approach to its international subsidiaries—and its experience with commercial banking in developing countries; Citi pointed out its success stories with buying up privatized Eastern European banks. The province's negotiation team no longer needed to explain its privatization plan to its bosses in Beijing. The FFI negotiation teams were quite eager to make the case themselves. When the second round of bidding ended in mid-2006 and the bidders could no longer outdo each other by offering more cash, Citi and Societe pulled not only financial but also political levers to come out on top. Henry Paulson, assuming the office of Secretary of the Treasury on July 10<sup>th</sup>, found himself making the case for his former competitor. The Bush administration was fully supportive of Citi's bids and was willing to negotiate with Beijing on the bank's behalf (Chen 2011). Similarly, Jacques Chirac made several trips to Zhongnanhai (China's leadership compound in Beijing) to make the case on behalf of Societe (Ibid).

The last stages of bidding in November/December 2006 would probably have gone down as a historic victory for FFIs and a turning point in China's financial liberalization. Citi's team, which now assembled a consortium of investors including IBM's investment arm and CITIC, succeeded in gaining Guangdong's permission to more than double their bid. Citi's offer stipulated that they were ready to pay a higher price, and would do so because they intended to be the largest shareholder in the consortium, which would buy up to 85 percent of GDB. Citi would hold 40 percent of the shares. Much like in the case of HSBC's 2004 gamble, this depended on Beijing



agreeing to implement on a precedent-setting exception to China's investment laws, which forbid any foreign entity from acquiring more than 19.9 percent of a Chinese state-owned financial institution. Guangdong agreed to the terms and said they would bring this possibility up with the State Council. The latter's response was short and to the point: they were carefully monitoring the bidding process and made no prior agreements to change China's laws then or in the near future (Chen 2011).

Citi now found itself in a conundrum. Societe made no stipulation that they would match this bid for just 20 percent of the bank. As such, they only had 2 choices: pay the most recently proposed amount for less shares and, in the grand scheme of things, no guarantees of managerial influence over the Guangdong-based lender, or backtrack and (almost certainly) lose the bid to Societe Generale. Backtracking on a big would be perceived as far more than a loss of face, and Citi opted for the former option (Chen 2011). In the end, Citi, along with its partners, IBM Investments, China Life Insurance, the State Grid Corporation of China, CITIC Trust, Price Waterhouse Investments invested 24.267 billion RMB to buy 85.5888% of GDB. Citi would hold 20%, China Life and State Grid would hold 20 percent each, CITIC Trust would hold 12.8488%, and Price Waterhouse's China subsidiary would hold 8% and IBM would hold 4.74%.<sup>31</sup>

The most notable result of the entire bidding process was that no effective privatization took place. There are two ways that this can be read. As per Walter and Howie (2012), we can understand it as a symptom of the broader trend of stalled financial reform, which they date to 2006. Walter and Howie have argued that as soon as it became clear that the partial privatization experiment (which, as the present analysis has stipulated, began in 1998 with the listing of China Mobile) allowed the Chinese government to continue to control the banking system and the

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<sup>31</sup> It should be noted that Pricewaterhouse Coopers was allowed to hold 8 percent because they used proceeds from their China-incorporated business. Chinese law, which prevents any individual foreign investor from taking more than a 20 percent in a domestic state-owned financial institution, also caps total foreign ownership at 25 percent. PwC China would not be allowed to transfer these shares to its parent company.

allocation of capital more broadly any discussion of actual privatization was off the table. Zhu's compromise was, in the end, so effective that it revered his reform platform almost entirely (this is the conclusion they draw in the 2012 edition to *Red Capitalism*). Under this scenario, FFIs may have had a strong ally in the local CCP cadres, but ultimately, could not change the CCP's firm stance on limiting foreign ownership in Chinese state banks.

But another way to see it is that FFIs ultimately misread the CCP's intentions—that the Party was serious about the restrictions on foreign ownership. As China opened its borders to goods and FDI, so too, they thought, it would open up to foreign capital. While they have made some non-trivial efforts to lobby as a group—for example, through their Chambers of Commerce, through their home governments, and through the SED, in the case of American institutions—few cooperative strategies have been forthcoming. Neither the SED nor the Chambers of commerce offered any kind of results-oriented lobbying strategy for FFIs (Interview with US Chamber Representative, 11 July 2013; Interview with EU Chamber Representative, July 18, 2013). The closest that FFIs have come to formulating a cooperative strategy vis-à-vis the CCP is the US Chamber's *Achieving 2020* Paper (American Chamber of Commerce 2012), which seeks to represent FFI interests in the Shanghai municipal government's efforts to make the city a global financial centre by 2020. However, the chamber's government relations arm has done little more than suggest the paper as relevant expert analysis in their regular meetings with Shanghai municipal authorities (Interview with US Chamber Representative, 11 July 2014). As such, there were few incentives for Beijing to acquiesce on any single FFI's demand for loosening foreign ownership rules. If one institution offers insufficient capital, or is unhappy with the existing rules of the game, dozens more are standing by to take its place. While the CCP stood united, FFIs were effectively caught in a prisoners' dilemma.

## 6.0 Systemic Obstacles: China in a Global Perspective

The informal/systemic barriers explored here are not a uniquely Chinese phenomenon. Although this study is fundamentally about China, it does seek to bring out important implications for the ways in which national governments can and do limit the power of transnational financial actors, even under conditions of openness. This section seeks to answer three related questions related to the systemic obstacles explored above: How does China's political economy compare to other rapidly developing emerging economies of the past, with respect to the systemic obstacles explored above (i.e. how common is the phenomenon of hollow liberalization)? And what makes finance different from other sectors? In other words, why are these kinds of barriers to market competition found in this sector rather than in others?

As Pearson (2005) has shown, and as a number of OECD reports have illustrated (Organization for Economic Cooperation and Development 1999, 2007, 2009), China, Japan, and Korea (respectively) have all pursued national variations on essentially the same policy logic: formal opening to foreign entry (such as permission to incorporate legally, *nominal* equal treatment of foreign enterprises under the law) with simultaneous reliance a number of measures to limit foreign competition. One way that these countries have done this is through instituting licensing policies that favour incumbent firms. As Pearson (2005, p. 319) explains,

the government uses licensing powers extensively across industries to direct policy and restrict market entry, rather than merely to set minimal conditions for doing business. When combined with considerable discretion on the part of the regulator and the absence of a thoroughgoing competition law to ban exclusionary practices, China has learned what Korea and Japan have long known: licenses are a powerful tool for restricting market entry of both foreign and domestic firms.

Another obstacle that we see in these countries is the regulatory preference for cooperative rather than competitive market entry: The Joint Venture option. In the 1970s and early 1980s in Japan, for example, JV-based FDI control policies were so effective that some scholars were commenting that American MNC-Japanese company JVs were effectively transferring American knowledge and expertise without getting anything in return (Reich and Mankin 1986; see also Francis 2003 and Lawrence 1993 on how the policy continued to an extent even after economic liberalization in the 1980s). But JVs were not the only means by which Japanese policymakers restricted access of their economy to MNCs. Even after these policy tools were being phased out, Japan's economy was still relatively inhospitable to foreign investment (Lawrence 1993). The importance of informal, structural barriers to MNC participation in emerging markets (systemic obstacles, as I have as I label them in this thesis) is their flexibility and adaptability as policy option, regardless of whether or not their discriminatory nature vis-à-vis MNCs is intentional.

A case in point is the Bush (Sr.) administration's 'structural impediments initiative' (SII)—a bilateral policy coordination agreement meant to address these kinds of obstacles to US MNCs' market entry and expansion into Japan (SII 1989). Under this initiative, both the American and Japanese negotiators agreed to modify the 'structural' barriers to business that the two countries saw to be affecting the fortunes of their respective MNCs in the other. But fundamentally, the issue was one of the US being unhappy with Japan and the barriers to US MNC investments that were seen to have caused a trade and investment deficit in the US vis-à-vis Japan (Mastanduno 1992). On the Japanese side, these included policy levers such as licenses and land use arrangements that benefited Japanese firms (ibid). Perhaps the most notable outcome of these negotiations was not that they happened, as the countries in question were close allies, but the extent to which the agreement (SII 1989), and subsequent redrafting of Japanese laws on foreign investment (see Francis 2003) did not change the logic of Japanese economy in the area of finance. In Japan, finance continued to be seen as something akin to an extension of the country's national security apparatus,

with continued reliance on the *Keiretsu* structure of interdependence between finance and the real economy, which ultimately precludes a greater role for FFIs in the Japanese financial system (see Mikuni and Murphy 2003 for an overview)

These kinds of phenomenon suggest that the financial sector might not be too dissimilar from other strategically significant industries such as telecom and energy, which experience a broadly similar, but more context-specific problem of obsolescent bargaining (energy security and geopolitics being key variables; see Vivoda 2008 for a recent study). In these sectors too, we see that while restrictions on foreign entry have been lifted in recent years, strict licensing requirements and a preference for JV entry still make energy and telecom, in practice, quite restrictive to foreigners (Organization for Economic Cooperation and Development 2009).

For China, of course, these systemic obstacles have been crucial in maintaining policy leverage over transnational actors because the country never really passed through a ‘developmental’ state period that other “late-industrializing” economies (Amsden 2001) have arguably passed through. Regardless of whether or not this stemmed from a deliberate vision of reformers under Jiang Zemin and Zhu Rongji in the 1990s and early 2000s, the impact was the creation of regulatory obstacles, which sapped the leverage of FFIs to take a greater market role in retail banking—the most important financial channel in bank-based economies like that of China. An important component of this—and the main feature that distinguishes China from other East Asian emerging economies of the past—is its maintenance of capital controls. Aside from giving China important policy leverages during financial crises (Lin, Sun, and Jiang 2013), this study shows that capital controls also erect important barriers to FFIs’ daily operations. Although a longer investigation into the precise role of capital controls—relative to the other systemic obstacles explored here—is needed, the data on FFI regulatory grievances presented in this thesis allows us to confidently claim that they play some significant role in limiting local incorporation and branch expansion by foreign commercial banking institutions.

China has opened its doors to FDI much sooner and at a much more ferocious pace than other East Asian economies. Indeed, as Huang (2003) notes, the distinguishing feature of Chinese capitalism in the 1990s was the disproportionate role played by FDI as a share of its total economic output. In Korea and Japan, we saw a much different story emerge, with FDI playing a very margin role in their development (Lee 1992; Lawrence 1992; Amsden 2001).

As such, capital controls form an important component of the obsolescing bargaining outcomes that we see in the FFI-CCP relationship. In the absence of the threat to pull out capital, which we saw play out in full force during the East Asian financial crisis, FFIs lose an important bargaining chip vis-à-vis Chinese regulators. But capital controls cannot be seen as the sole variable in this equation. Bank-based financial intermediation and the related variable of the incumbency advantage for domestic banks—banks' relationships with domestic corporations and SMEs, as well as their extensive networks of branches that appeals to a vast majority of all but the wealthiest, most internationally-connected depositors—makes the financial sector in many emerging economies a problem for even the largest international banks.

In China during the 1990s in the manufacturing sector we saw domestic firms comprised of a host of small private factory owners lacking in viable access to capital and a large network of highly inefficient SOEs starved of modern technology and profit-oriented managerial incentives. Gallagher (2011) has shown how SOEs were reinvigorated by learning from the labour and managerial practices of MNCs, which provided jobs not only for laid off workers from the state sector but also for a large pool of rural migrants. They learned from Taiwanese, Japanese, and American firms, who manufactured for foreign markets and adopted these practices to manufacture for domestic consumers.

In the area of finance, the story could not be any more different. The problem for the Big Four banks (and the Bank of Communications) was not a lack of customers (they had the state sector and depositors locked down), but a way to serve their clients while maintaining long-term solvency. Moreover, because in China, as in Japan, Korea, Taiwan, and other former East Asian

late-industrializing countries, banks are (or were) an essential pillar of policymakers' development and crisis management strategy (see Lee 1992; Yoo and Lee 1987; Levi-Faur 1998; Sue 2008; Campbell II and Keys 2002), the practice of "selling China" (Huang 2003) that we saw in the case of the manufacturing sector could not so easily be transplanted into finance.

Not surprisingly, China is not the only large market that has disappointed FFIs. Japan, also not known for being a foreign bank success story, has seen some foreign commercial bank retreats since the government began to seriously implement the 'Abenomics' policy of negative real interest rates. This policy was seen as the last straw for banks that were already facing an uphill battle in competing with foreign banks that have had a loyal pool of corporate, SME and depositor clients; not to mention implicit government subsidies that make it easier for Japanese banks to operate with extremely thin margins and with record-low interest rates (McNeil 2015). In Korea, we see a very similar story, with HSBC shutting down its retail banking operations in the country entirely in 2013 (Mundy 2013). As one Korean banker recently remarked, "The financial services sector is seen as a quasi-public utility that should help the growth of the manufacturing sector rather than an industry that stands alone and that should make profits, reinvest and grow" (quoted in Mundy 2013).

## 7.0 Conclusion

This chapter has examined China's financial regulatory environment from the point of view of FFIs, looking at the regulatory grievances that have been persistently registered in the European and American chambers of commerce annual position papers (along with PriceWaterhouse Coopers annual industry surveys on *Foreign Banks in China*, and anonymous interviews conducted with FFI managers, financial journalists, foreign diplomats, and chambers of commerce representatives in Beijing and Shanghai), and gives some examples of FFI lobbying after China's WTO accession. Examining the data obtained from coding the chambers' documents, and filling in empirical gaps

in this data with these other sources, I argue that while China's WTO accession lifted formal legal barriers to market entry and expansion, FFIs continue to be hampered by a number of systemic obstacles. These include 1) a regulatory framework that favors incumbent banks, 2) the dominance of bank-based lending, 3) the persistence of capital controls, 4) close-knit relationships between large SOEs and large banks, and 5) the underdevelopment of domestic equity markets.

From the perspective of the foreign banks themselves, direct discriminatory measures comprise an insignificant part of their grievances with respect to entering and expanding in China. This might constitute a counterintuitive conclusion, since FFIs own no more than two percent of financial assets in the Mainland financial system. But in the context of the argument advanced in this thesis, the findings actually conform to the hypothesis outlined in the introductory chapter. That is, FFIs have played an important role in prompting external liberalization of China's Mainland financial system. However, they have done so in a way that actually precludes the need for greater participation by foreign enterprises in the mainland financial system. In chapter two, I explained how this is a contemporary example of the obsolescing bargaining dilemma that MNCs sometimes face vis-à-vis host governments. This chapter has focused on outlining the obstacles faced by FFIs in China's domestic financial system, while chapters 4 and 5 will show how FFIs' role in China's financial evolution has, quite ironically, helped to institute these obstacles.

The perspective of foreign banks in entering and expanding in China's financial system since 2005 can be seen as a useful proxy for gauging the idiosyncrasies and complexities of financial liberalization. What we find is that China has done much to open up its financial sector to foreigners—especially since it joined the WTO. Additionally, while we cannot directly deduce the intentions of China's policymakers from this study, looking at FFIs' lobbying grievances since China's WTO accession helps to get a better understanding of China's complex relationship with the FFIs as agents of the global financial system. Moreover, we can get a better idea about what terms such as liberalization and global financial integration mean in the Chinese context. This also sets the stage for the next two chapters. Keeping in mind the evidence presented here, the next



chapter outlines China's decision to outsource a large portion its capital markets, and increasingly its debt markets, abroad—not only to its own globally integrated H-share (Hong Kong) markets, but also to other global financial centers like New York, London, and Singapore. It describes how, by gradually making its regulatory framework more amenable to foreign needs and (perhaps inadvertently) sending Chinese companies to raise money abroad, policymakers in Beijing have been able to 'have their cake and eat it too:' to employ the capital and expertise of FFIs without giving them a significantly greater role in China's domestic financial system, all the while complying with the country's WTO commitments to external financial liberalization. I will show how, by participating in China's spatial and elite-based internationalization, FFIs have essentially contributed to putting in place the systemic obstacles that the preceding chapter has described.

## **Chapter 4: Spatial Internationalization and the Unique Role of FFIs as a Bridge Between China and Global Finance**

### **1.0. Introduction**

China's financial sector is typically portrayed as among the most closed, or CCP-controlled sectors of the country's economy. Even Lardy's (2014) recently positive assessment of the Chinese economy ranks China's financial sector as among the least 'liberalized' in its economy. Yet, as this chapter will illustrate, discussions of liberalization, or lack thereof, obfuscate the more relevant and more interesting characteristics of China's financial sector reform. While the Mainland banking sector has managed to avoid privatization and foreign participation for the most part, China's financial markets—as defined by 1) fund management and expertise, 2) financial assets, and 3) reliance on foreign institutions—have undergone a process of outsourcing as early as 1993—the year the National People's Congress approved the first set of state-owned firms to list in Hong Kong and New York. In fact, China is distinct from fast-growing East Asian economies of former fame (Taiwan, Singapore, Korea, Japan, etc) in that it did not wait for its financial markets and managerial expertise to catch up to those of developed countries before allowing foreigners to participate in financing the restructuring of its state-owned enterprises. Instead of waiting for its domestic stock exchanges to develop and before waiting for a domestic capitalist class to emerge—that could manage and direct financial capital in an efficient way (or, at least, direct it efficiently to state-favoured projects)—China's central government simply outsourced this function to FFIs and to global stock exchanges (most importantly, Hong Kong).

Recurring debates concerning the liberalization of the Chinese economy consistently mischaracterize the bifurcated nature of the country's financial sector. Typically, the discourse of

liberalization presents a dichotomy of state control versus the market-based allocation of resources. This not only mischaracterizes the nature of the global financial system (i.e. it presumes global financial markets to be inherently inimical to state intervention) but also mischaracterizes the extent to which China's financial system is a fortress cut off from the global economy and from global capital markets.

Perhaps even more significantly, it almost entirely ignores the role of Hong Kong in creating linkages between China's domestic economy and global capital markets—almost as if to suggest that the Special Administrative Region is not under the federal jurisdiction of the PRC. Much of the discussions on China's financial reforms tend to ignore the efforts by Hong Kong's local state and non-actors in piloting China's financial internationalization along the track of global listings. As the discussion in this chapter will show, FFIs' key role in leading Chinese SOEs to list on global stock exchanges largely piggybacked on the regulatory innovations of Hong Kong's policymakers and small securities firms, who pioneered the legal and institutional framework for corporatizing Chinese government entities.

This underscores the spatial character (Sassen 2002) in which internationalization of financial services has occurred in China. While not negating the real barriers to foreign capital in China's Mainland financial markets, this chapter explores the ways in which FFIs piggybacked on the changes in Hong Kong's financial sector and its relationship with China. These changes date back to as early as the 1990, and culminate with events that eventually saw FFIs take Chinese SOEs public beginning in 1997. This piggybacking eventually created parallel financial markets to its tightly controlled domestic exchanges in Shanghai, and Shenzhen. It also underscores that FFIs' role in creating the modern Chinese SOE was not as significant as that which was proposed by Walter and Howie (2012). As noted in the introduction, it emphasizes that FFIs were *one set of actors* among a larger constellation of actors—including the CCP, Hong Kong authorities, local Hong Kong firms, among them—that made China's financial internationalization possible.

This chapter looks at the listing of China's state-owned firms in New York, Hong Kong, and elsewhere, and explains these changes as examples of spatial internationalization through the practice of 'offshoring' of equity markets. It focuses in particular detail on the role of Hong Kong in fostering spatial internationalization, with a particular attention to the role of Hong Kong as a novel kind of offshore centre (Palan 1998) for Chinese financial markets. With an eye to the important role played by FFIs in the process, it draws on Lai's (2012) study of how foreign banks use Hong Kong, Shanghai, and Beijing for different purposes. It illustrates the ways in which this spatial segmentation allows China to, in effect, 'have its cake and eat it too,' as it gains full access to global capital markets while maintaining capital controls and state ownership of the allocation of capital at home. This, in turn, explains how FFIs have helped to create the systemic obstacles described in the previous chapter—particularly those related to capital controls and the dominance of state-owned banks in China's financial sector. It shows how FFIs leveraged international financial markets to fund China's SOE and later state bank restructuring, thus forgoing the immediate need to introduce foreign capital into the Mainland financial sector.

This chapter consists of 4 main sections. Section 2 will outline the role of Hong Kong as a Chinese financial offshore. This section proceeds in three parts. The first section will provide a theoretical overview of the role of Hong Kong as a vehicle for spatial internationalization of financial services in China. The will draw heavily on Palan (1998)'s notion of the 'offshore centre' in global finance and Sassen's (2002) notion of the 'Global City,' to explain the unique role of Hong Kong as an offshore 'hub' that played a key role in the outsourcing of financial services development and linking Chinese state companies with global capital markets. The second part will provide a brief overview of Hong Kong's integration with Mainland China since the handover to the PRC in 1997, with particular attention paid to the integration of financial services and the growth of the city as a global financial centre. The third part will briefly examine the role played by foreign banks in this integration. Section 3 will look closely at the concept of spatial internationalization that was introduced in the introduction. It will explain the role played by FFIs

in creating the offshore space for Chinese equities and helping Chinese policymakers restructure state enterprises and to harness global capital markets to finance this restructuring. Section 4 will look closely at the pivotal role played by Goldman Sachs in helping Chinese policymakers to utilize international capital markets and the role that Goldman and other banks played in the political compromise that gave way to China's present strategy of creating China's state-owned industrial giants—its 'National Champions.' Section 5 will look at FFIs' role in the most recent round of listings of China's Asset Management Companies (AMCs), the NPL disposal institutions, and it will suggest that foreign investment banks have persisted in their role of helping Chinese state enterprises restructure and raise capital on global stock exchanges.

## **2.0. Hong Kong as an Offshore Hub**

### *2.1. Conceptualizing the role of Hong Kong in China's Financial Internationalization*

What role did the small former British colony play in creating linkages between China's financial markets and the global financial system? While it is beyond the scope and goals of the present study to recant the decades-long (and arguable exhausted) debate on the question of state sovereignty under conditions of economic globalization, this question begs recounting at least one part of it. Ronen Palan's examination of the unique role of offshore financial centers—localities that act as extraterritorial shelters for global firms seeking to minimize their exposure to national regulations and taxation schemes that cut into their bottom line—showed us that states often deliberately create or rely on extralegal localities to, quite paradoxically, preserve their national sovereignty.

As he describes it, the concept of the offshore “captures simultaneously two sets of instrumental realities. It is a case of having your cake and eating it: maintaining the state system as organizer and mediator of conflict and tension, yet removing the threat of regulation and taxation

attendant with the state—all done in the name of and by the state system itself” (Palan 1998, p. 627). While he used this idea of ‘having your cake and eating it too’ to describe how states resolved tensions between economic integration and sovereignty, it can be quite smoothly applied to the ways in which China has been, since 1997, using Hong Kong to resolve tensions between its drive to open its economic borders and maintain the CCP’s sovereignty over the allocation of capital to achieve what some Chinese scholars have characterized as a policy of ‘financial security’ (Yeung 2008).

Another framework that helps us to understand why Hong Kong has come to be a central global node, linking China to the rest of the world—and vice versa—is Sassen’s notion of the global city. According to Sassen, global cities possess a number of characteristics, stressing the importance of these places as ‘post-industrial production sites,’ with corporate services and finance forming underpinning economic activity in these centers; they serve as ‘command points’ in today’s global economy (they concentrate a disproportionate amount of economy activity in a small locale). Saskia Sassen (2012) briefly describes Hong Kong as a global city—a place that links the myriads of production nodes in the global economy, thereby controlling a disproportionate degree of global production. She notes the importance of the city as a global financial centre and its dependence on the Mainland, as well as its complimentary role vis-à-vis the more diversified city and financial centre of Shanghai.

However, Sassen’s analysis is not precise about the defining characteristics that describe a global city, making it difficult to pinpoint the precise role that Hong Kong plays vis-à-vis China and, for the purposes of the present analysis, unclear about how China’s spacial internationalization takes places in and through the city. Fortunately, Sassen’s analysis has been taken up by a number of political risk and consulting firms that have created their own respective indexes to rank global cities (not incidentally, Hong Kong consistently ranks among the top 10 scored global cities). Drawing from Kearny’s (2014) annual Global Cities report, The Mori Memorial Foundation’s

(2014) Global Power City Index, and the Economist Intelligence Unit's (2014) Global City Competitiveness Index, we find seven common characteristics among them.

- Economic strength (regional market integration, GDP per capita, etc)
- Financial maturity (the sophistication and resilience of financial markets, financial products diversity, and openness to capital)
- Physical capital and infrastructure
- Human capital (education level and sophistication of the labour force)
- Attractiveness for financial institutions and non-financial multinational firms (are banks and corporations willing to locate regional head offices there?)
- Quality and independence of local media and information channels
- Rule of law and institutional strength

These characteristics are important not because they underpin Hong Kong's ability to attract global capital and, more specifically, because they make it attractive for foreign financial institutions to locate there.

When China retook control of the city in 1997, it was handed an important asset: a territorial enclave where capital flowed freely, and which had many institutions, like the rule of law, high quality post-secondary education, and financial markets that bankers and investors trusted. However, not all global cities can be offshores (Toronto, for example, is a former, but certainly not a latter), just as not all offshores can be global cities (Luxembourg and the Cayman Islands have more characteristics of the latter than the former). But in the case of Hong Kong, the attributes of a global city dovetailed quite smoothly with the island's characteristics as an offshore: they reinforced and developed symbiotically. Since China's reform period began in 1978, the island quickly transitioned from being the UK's enclave of laissez-faire capitalism—in a sense, it was the UK's own personal offshore—to the world's gateway to China. Hong Kong businessmen, due to

encouragement and/or deliberate neglect of Guangdong Province's authorities, established businesses and joint ventures in the mainland. Chinese provinces, strapped for cash and propelled to find alternate fund-raising channels by the CCP's adoption of fiscal decentralization in the starting from the mid-1980s, turned to foreign financing through the Investment and Trust International Corporations—the infamous 'ITICs', many of which closed their doors following the 1997 East Asian Financial Crisis. The ITICs were incorporated in Hong Kong and lent money in China, for the most part to local governments, and allow foreign investors a backchannel to invest in infrastructure and, later, real estate development in coastal provinces. This was, in effect, the very first business strategy employed by foreign bankers in the China market (Lu 2007).

Hong Kong's image (and reality) as a gateway to China made an important contribution to the island's transformation into a global city. The informal, uncoordinated, and backchannel-like ways in which the island's development with the Pearl River Delta proceeded into 1997 (Yang 2006) cemented its status as an offshore. Moreover, the "one country, two systems" policy adopted by Deng Xiaoping vis-à-vis the island effectively gave political support to its image as an offshore. Moreover, as I will detail in the next subsection, official linkages like the Hong Kong-China free trade agreements (the CEPA accords), and a number of financial markets linkages developed since 1997, formally institutionalized Hong Kong as a Chinese offshore in everything but in name.

To put it another way, prior to political reunification with the mainland in 1997, Hong Kong grew closer to China not because of deliberate government policy (Yang 2004 notes that official government-to-government contact and coordination was actually quite minimal even after the start of the reform period in 1978) but due to a policy of benign neglect. As movement of people across the Hong Kong-Shenzhen border was liberalized, and as the Shenzhen Special Economic Zone flourished, growing economic activity and contact between the two cities facilitated the growth of the city as a gateway between China and the rest of the world. Underscoring Sassen's emphasis of global cities reflecting a shift to global services and finance on a global scale, Meyer (2000) demonstrates how the decline in Hong Kong manufacturing and the shift from being an



exporter to an importer of capital in the 1970s aided in its transformation into a globally significant centre for services—especially financial services.

What I propose here is that Hong Kong, partly through a series of policy initiatives and partly through happenstance, became a ‘global city’ through its function as an offshore hub for Chinese firms raising capital and undergoing corporate restructuring. These changes were underpinned by a number of ‘natural’ attributes that made the city an appropriate destination for the development of a Chinese ‘offshore’ financial centre. In turn, foreign banks were important actors in linking Chinese equities to global capital markets through the island. They brought corporate finance and corporate governance expertise, and stoked institutional and retail investor interest in the brand new corporate entities that would be modeled on the 1997, Goldman Sachs-led China Mobile Initial Public Offering (IPO).

## *2.2. Why Hong Kong?*

Sassen’s work is important for the present analysis because the idea of a global city provides an expansive and broad framework for understanding why certain states choose particular locations for their offshore hubs. To put this into perspective, we can, for example, ask why the Hong Kong Stock Exchange became the favoured destination for mainland SOE listings in the 1990s, instead of, for instance, Singapore. Much like Hong Kong, the latter also offered an offshore locale with characteristics of a global city very similar to those of the SAR, including well-developed capital markets, and a cultural affiliation with China; it also had a growing pool of financial industry talent and ambition to piggyback on China’s growth. However, being a global city (or a potential global city) is not enough, at least from the standpoint of FFIs looking to profit from China’s growth. As foreign bankers working in China have stated in a number of interviews, and as Lai (2012) points out, Hong Kong has thrived as an offshore gateway into the Mainland that

allows both FFIs and their Chinese company clients to interact in such a way that makes the Island a channel between the policymaking that takes place in Beijing and the business decisions that are made by FFI head offices elsewhere. China's reform process starting in 1978 had, in many ways, allowed this relationship to form and allowed foreign investment bankers, in particular, to become involved in China's financial and SOE reform process. It allowed foreign bankers to show Chinese policymakers what well-developed capital markets can achieve—not only in terms of raising funds for reforming the ailing state-sector, but in completely reorganizing it as well. The early experimentation with IPOs and equity fundraising by state-owned companies in Hong Kong soon allowed Chinese policymakers to raise even more money in global financial centers like New York, London, and Singapore. This section explores the role of Hong Kong in this regards, and the two subsequent sections focus more squarely on the role of foreign banks in helping policymakers in Beijing create well-functioning equity markets and to transform and centralize disparate locally owned assets, eventually crafting them into what are today known as China's 'national champions.'

To be sure, the role of foreign banks in internationalizing Chinese equities is not the story of Hong Kong as an international financial center per se. As will be explored in more detail below, other financial centres, most notably New York, also played an important role in helping Chinese companies raise capital abroad. However, Hong Kong's development as a global financial center took place at a very conspicuous time. In the late 1970s, Deng Xioping changed the course of Chinese politics by piloting the policy of Reform and Opening Up (改革开放) in the then small coastal city of Shenzhen. This occurred around the same time that the British colonial administration began to take deliberate steps of making the island an international financial centre (Chiu and Liu 2009). The two processes converged in such a way that not only drew foreign financial actors to Hong Kong but also helped to create opportunities for emerging Chinese state enterprises to sell shares on the Island's increasingly popular stock exchanges.

This confluence of factors took place through a series of policy changes in Hong Kong that, in combination with China's economic growth and the reform of its state enterprises (explored in detail in the section below), drew foreign investment banks to locate their China headquarters in Hong Kong, thus contributing to the status of the island as an international financial centre and an offshore access point to the Mainland. The three major changes in Hong Kong were: 1) the re-stabilization of the Hong Kong dollar-US dollar exchange rate system in the early 1980s; 2) the amendment of the Hong Kong Exchange listing rules to accommodate Chinese state-owned enterprises seeking to raise capital in the city's stock market (and later, the establishment of the Growth Enterprise Market to accommodate smaller Chinese firms); and 3) more ubiquitously, the Hong Kong-Mainland Closer Economic Partnership Arrangement (CEPA).

The first set of policy changes that attracted foreign banks to locate on the Island was the Hong Kong Monetary Authority's management of prices and the value of the Hong Kong dollar. Until 1972 the Hong Kong dollar was tied to the British sterling. That year, the city's colonial government decided to, instead, switch to a US-dollar based fixed exchange rate system. However, following repeated speculative attacks on the US dollar and the broader instability among exchange rates across the global economy in the 1970s, the exchange rate in Hong Kong was marked by uncertainty and instability. Coupled with the city's decline as a manufacturing-based economy, the colonial government began an effort to attract global capital to the city, starting with creating a stable and reliable exchange rate system (Chiu and Liu 2009). On October 15<sup>th</sup> 1983, the financial authorities pegged the Hong Kong dollar to the US dollar at an exchange rate of 7.8 to 1. Since then, the city's Monetary Authority used a currency board system to manage exchange rate and price pressures. Its efforts were apparently rewarded, as the city moved from being a net capital importer to a net capital exporter. By the early 1990s, it had accumulated the third-largest foreign exchange reserves in the world and the fixed exchange rate system was seen as stable and reliable by Hong Kong-based and international investors alike (Chiu and Liu 2009).

Starting in 1990, it was already clear that Mainland-based companies would look to Hong Kong for at least part of their financing needs. After 3 years of negotiations between Hong Kong financial regulators and representatives from the People's Bank of China (there was no dedicated securities regulator at the time), a set of changes were implemented to make Mainland enterprises' fund-raising efforts on the Hong Kong stock exchange regularized and predictable. Nine state enterprises were approved to list in Hong Kong on 6 October 1992: this was the pilot project for what became known as H-share companies—state-owned Chinese enterprises, incorporated in the Mainland, with minority shares floated in Hong Kong. On 17 June 1993, what was then called the Stock Exchange of Hong Kong announced amendments to the Listing Rules of the exchange solely for the purpose of giving legal exceptions to Mainland companies to issue shares on the exchange. The new rules allowed Chinese government entities to issue shares notwithstanding the exchange's strict requirements on balance sheet disclosure, reporting on past revenues (the company should be profitable for a number of years) and growth prospects, as well as the requirement for the listed entity to be answerable to its shareholders. These exceptions went largely unnoticed at the time (for all but the most avid China watchers) but they represented a big step forward for the corporatization of Chinese state entities, which at the time still operated as *danwei* (work units), rather than companies as we commonly understand them.

At the time, the amendments mainly stipulated listing for H shares in Hong Kong. On 19 June 1993, the newly established China Securities Regulatory Commission (CSRC), Shanghai Stock Exchange, Shenzhen Stock Exchange, Hong Kong's Securities and Futures Commission (SFC) and SEHK signed a memorandum of understanding on Sino-Hong Kong regulatory cooperation in the Great Hall of the People in Beijing. This was the formal ribbon-cutting ceremony with official approval (from both sides) of Mainland enterprises raising capital in Hong Kong, along with the opening of information sharing channels and investor protection measures. Tsingtao Brewery was the first to list. Its shares started trading on the Exchange on 15 July 1993. The second

batch was announced on 27 January 1994. There were 22 companies, mainly from heavy industries such as energy, transport and raw materials.

The third change that helped bring FFIs in greater numbers to Hong Kong was official cooperation on financial services between Mainland and Hong Kong regulators. This cooperation was legislated in the form of a free trade agreement called the Mainland/Hong Kong Closer Economic Partnership Agreement (CEPA) in 2004. CEPA made it clear, as per the wording of the legal text, that “The Mainland supports the full utilization of financial intermediaries in Hong Kong during the process of reform, restructuring and development of the financial sector in the Mainland” (Government of Hong Kong 2004, p. 7). But more importantly, the agreement quite explicitly acknowledges in an official capacity of the structural changes that had already had the effect of making the city an offshore hub for the restructuring of China’s SOEs and for the development of Chinese equity markets along international standards. As head of research at the Hong Kong Exchange put it, “These measures are to some extent existing policy directions which were already in effect” (Harrison 2004, p. 3). This is because starting from the 1980s, both cultural and political factors had drawn Chinese companies to Hong Kong, and it was only a matter of time before foreign banks would take the advantage to court SOEs to raise capital there. Hong Kong’s proximity to China, cultural and economic linkages with the Pearl River Delta (Yang 2006), coupled with already well-developed capital markets and openness to capital, made it a natural choice for the growth of China’s capital markets outside of its borders. Additionally, cultural disparities between retail and institutional investors in other global financial centers—places like London and New York, where Chinese SOEs would later make historic debuts—as well as significant information asymmetries made the island a natural starting point for the growth of Chinese equities outside of China. Hong Kong regulators consistently updated the rules of the Hong Kong exchange to make it easier for a growing number of not only state-owned but also private companies, to list there (Harrison 2004). In turn, foreign investment bankers made it their priority to direct capital to fund the restructuring of state assets in the Mainland (Paulson 2015).

These regulatory changes were driven not only by the island's structural economic transformation (the city was experiencing a slow but steady process of post-industrial decline, driven in part by the rise of China as a global manufacturing hub [Meyer 2000]) but by political factors related to the looming return to Chinese sovereignty. In the early 1990s, many Hong Kong citizens, especially the native financial community, were nervous about the return of the island to Chinese sovereignty—so much so that starting in the mid-1980s and through the mid and late 1990s as many as 60, 000 Hong Kong residents emigrated out of the Island (Courtney and Holley 1992). Because this deprived the city of the much-needed professional financial expertise that was essential to the colonial government's goal of building up the Island as destination for global capital, the city's officials began to change its regulatory structure to make it easier and more attractive for global FFIs to incorporate and open offices in the city. The problem, however, was that advantages to doing business in Hong Kong (as opposed to Tokyo, a more dynamic city at the time) were few and far in between. But FFIs—especially investment banks—noticed what was as late as the mid-1990s, a growing niche opportunity that would later come to completely define the Island's political economy and its economic identity more broadly: restructuring and listing Chinese state-owned enterprises (Paulson 2015).

Catching on to this niche, global financial actors began to use Hong Kong as a bridge connecting the aspirations of China's reformers (this will be explored in detail in the next section) and the availability of capital in Hong Kong and elsewhere. Channeling foreign capital into Chinese equities was not an easy task until the Goldman Sachs-led restructuring and listing of China's most valuable telecommunications assets in the groundbreaking China Mobile IPO (explored in detail in the next section). However, the Mainland China teams in Hong Kong-based investment banks like the Jardine Flemming, HSBC and Hang Seng (not to mention a plethora of smaller 'investment houses') spent the better part of the 1990s conceiving creative ways of helping local Chinese governments attract capital (at the time, the modern Chinese SOE did not yet exist as an organizational concept, and many of China's state-owned companies were under the direct purview

of provincial and city governments). One of the first innovations in this regard was the use of the so-called ‘ITICs’ (International Trust and Investment Companies)—Hong Kong-incorporated, local government-owned investment vehicles that borrowed money directly from foreign investors and then channeled them into property development and other infrastructure projects in the Mainland. However, with the famous collapse of Guangdong-based GITIC, the biggest and most internationally-connected of the ITICs, the experiment suffered a blow and effectively died with China’s financial restructuring of the early 2000s (Walter and Howie 2012).

But the ITIC was not the only backchannel for foreign bankers and investors to access the fast-growing China market. Equity-based investment, which started small, came to be the most important innovation of the increasingly globally rooted Hong Kong-based investment bank community. While all the credit should not be given to FFIs—after all, as mentioned above, Hong Kong financial sector policymakers were quite actively encouraging Mainland local government fundraising activities through regulatory changes—much of what Hong Kong’s colonial administrators and the reformers in China’s central government did amounted to catching up to private institutional innovations that were already underway in Hong Kong. Prior to official recognition of Mainland companies issuing shares in Hong Kong in 1993, investment bankers based on the island had already figured out two ways for Chinese local government-owned companies to issue shares. The first of such methods, the backdoor listing method, involved having the SOE purchase a company already listed on the Hong Kong Stock Exchange, thereby acquiring local incorporation status. This allows the SOE to issue further shares, as they legally gained the status of a locally incorporated company. A few of the most internationally oriented Chinese companies such as China Everbrite Group and CITIC Pacific (and Asia investment arm of China’s first and state-owned investment bank CITIC) offered shares with this method.

Another way to issue shares was to directly establish a locally incorporated subsidiary of an SOE, and to run a profitable operation for at least five years. Hai Hong’s listing on the Hong Kong Stock exchange actually followed this route, as the company was a subsidiary of China

Merchants Group (Pang 1998). It is worth noting that the ‘first’ group of 8 SOEs to list in Hong Kong in 1993 was actually the first group to be approved to list directly by the central government. By then, the Hong Kong investment community was already familiar with SOE listings.

In 1992, Alex Tang, the lead researcher for Dao Heng Securities, coined the term ‘red-chip’ to describe Hong Kong-listed companies that were subsidiaries of Mainland local government-owned SOEs and developed the first Hong Kong-listed Mainland Company stock index—long before the now prominent Mainland companies’ indexes put together by Hang Seng Bank (Sharp 2001). Capital flooded the city, stoked by Hong Kong investment banks and securities companies, soon to be joined by Merrill Lynch, Morgan Stanley and eventually (and decisively) Goldman Sachs, who sold the ‘China concept’ to investors across the world (Lo 1996). As early as 1992, there were at least 360 companies that bore the mark of the ‘China concept’ (Lo 1996). While many of the early Red-Chip companies were regarded as speculative investment opportunities (South China Morning Post 1993), with large institutional investors and fixed income portfolio investors staying away (Lo 1996) smaller Hong Kong-based securities firms saw a niche market: a way to connect more minor investors (i.e. Hong Kong’s small but growing middle class) to a new asset class that lacked willing institutional buyers.

By the late 1990s, increasing investor awareness of China’s rapid growth assured that it would not be long before institutional investors and pension funds would pour money in to Red-Chips as well. While at the beginning only local (i.e. Hong Kong-based) investment banks and securities brokerages were selling Chinese equities in the city, by the end of the decade much of the money came from foreign institutions increasingly willing to establish operation in Hong Kong. In this respect, FFIs were actually late-comers to a game that was already being played by local financial entrepreneurs. Paulson (2015), for example, readily admits that Goldman Sachs under-appreciated the value of Hong Kong as a global space and access point to Chinese clients until Wang Qishan—then head of CCB—approached him in 1996.



After China Mobile made its debut on the Hong Kong Exchange in late 1997, foreign interest in Chinese equities shot up quite substantially (albeit, it was already on the way up in the years leading up to the IPO). The data on the sources of funds raised by the top 10 Chinese SOEs in Hong Kong between 1997 and 2003 reveals that 88.8 percent of the money originated outside of the Island (Lee and Chang 2003). This underscores the key role that FFIs played in the process outlined above: after recognizing the value of local efforts, they took the corporatization project to a global level.

It should be noted that selling Mainland SOEs to global pension fund and portfolio investors was not easy task. To begin, Chinese reformers, following the enormous success of the China mobile IPO (explored below), were keen to offer foreign investment bankers favourable IPO fees and to bring these banks in as strategic investors (which will be explored in detail the next chapter) by offering them cheap equity buy-ins and favorable exit terms (Asiamoney 2005). The goal of China's reformers was quite clear: to give foreign bankers enough incentive to bring in fund managers on board with the increasingly high valuations of Chinese companies. In another important IPO—that of the Bank of Communications—Goldman Sachs and HSBC undertook extensive tours across New York, Hong Kong, and other financial centers to convince fund managers of the value of the restructured BOCOM (Euroweek 2005a). As one equity capital markets specialist at the time put it, “They started out with blank pieces of paper. They had no benchmark by which to value BoComm, and were surprisingly unknowledgeable about the sector, despite having known for some time that the Chinese banks were due to arrive in force this year and next” (Quoted in Euroweek 2005a). Contrary to the narrative that we have seen over the past decade, whereby FFIs clamored to invest in Chinese financial institutions as they prepared to go public (this will be one of the FFI strategies explored in the final chapter), it was not until mid-2005 that global money managers began to throw money at Chinese SOEs in droves.

In fact, listings in Hong Kong were hitherto traded at a nearly 20 percent discount to the valuations in their simultaneous A-Share IPOs in Shanghai and Shenzhen (Euroweek 2005b) and

would only converge in value later in the 2000s (Walter and Howie 2012). For much of the 1990s and early 2000s Chinese policymakers used their FFI agents to sell the idea of SOE reform to the world. Indeed, it was not until HSBC agreed buy 19.9 percent of Bank of Communication Shares, with Goldman Sachs and the former acting as joint under-writers and the latter advising the bank on their pre-IPO restructuring and prospectus (Paulson 2015), that Chinese state-owned bank managers were flooded with requests from foreign bankers to play the role of ‘strategic investors’ in the pre-IPO process (Euroweek 2005a). HSBC’s BOCOM shares in Hong Kong jumped nearly 13 percent on the first day of trading. As Henry Paulson put it in his memoirs, HSBC, which had gone out on a limb to buy its 19.9 percent stake the previous summer [of 2004], now looked brilliant and the dynamic for investing in Chinese banks suddenly changed” (Paulson 2015, p. 167). With the signing of the CEPA agreement between the Mainland and Hong Kong, it appeared that Chinese policymakers understood what global capital markets and their intermediaries could do for them.

As Chen (2013) describes it, by the early 2000s policymakers in Beijing began to understand how important the city and its proliferation of Mandarin and English speaking financial and legal professional was for its ‘developmental’ policy of transforming SOEs and state-owned banks into global competitors. These agents of global capital and financial markets expertise knew how to restructure and price Chinese companies. Transforming Chinese stock markets to raise enough capital for SOE reform was a herculean task with a great many pitfalls (Green 2003); transforming SOE management at home was, and continues to be, perhaps an even more protracted challenge (see Kang, Shi, and Brown 2008 for an in-depth overview). But thanks to the presence of these agents in a Chinese-controlled offshore—and no less in one right next door to the dynamic province of Guangdong, from where much of the tangible assets that would make the prospectuses the newly-formed SOEs look so attractive would originate—this process could be postponed. As the previous chapter argued, this is precisely why Chinese policymakers would opt for internationalization before undertaking domestic reform: FFIs like Goldman Sachs and HSBC, over the course of the 1990s and early 2000s, would show them that this was a more palatable option.

### 3.0. Explaining Spatial Internationalization: The Domestic and International Origins of Chinese Overseas IPOs.

China Telecom raised \$4.2 billion (USD) on the Hong Kong Stock Exchange on October 23 1997, would soon become among the best performing stocks in East Asia, and would climb up in value by 13 percent by end of the year—in the face of the raging East Asian Financial crisis. However, the listing was a breakthrough not only for the newly formed, modern—or, at the very least, modern-looking (Walter and Howie 2012)—China Mobile, as it would later be called, but for the Chinese government and for foreign investment banks as well. This is because, until that moment, many of the overseas listings of Chinese firms were experimental, blunt attempts at raising capital—and not very much capital at that. As a number of participants have noted (Walter and Howie 2012; Paulson 2015; Das 2007; Greenberg and Cunningham 2013), the 1980s and early to mid-1990s were, in effect, an educational decade for Chinese officials who sought out foreign investment bankers and other financial professionals quite simply to learn what investment banking *was*, let alone how it could help China reform its state-owned enterprises.

The first trial of an SOE to list on a global stock exchange (Hong Kong was not a truly global financial center until the mid-2000s) was, slightly contrary to the narrative offered here, on the New York Stock Exchange (NYSE), when a collection of local government automotive assembly plants and distribution outlets from the city of Shenyang in Northeastern Liaoning province were cobbled together with the view of being incorporated into China's first-ever corporatized entity. What were the origins of this pilot 'privatization' scheme? A number of reform-minded officials at the PBoC, in consultation Credit Suisse First Boston, created a holding company in Bermuda, which then listed its shares on the NYSE. These shares, however, were ultimately

minority assets of a Mainland corporate entity whose majority owner was the Lioing government.<sup>32</sup> Moreover, the initiative came directly from the aforementioned experimentally minded PBoC officials (Interview with former FFI manager by phone, 23 May 2013). But the role of foreign investment bankers and their team of lawyers and facilitating and carrying out this initial experiment should not be understated. These international actors allowed Chinese authorities to navigate the complex US securities regulatory framework to benefit from securities regulations in hitherto unintended ways. Global investment bankers involved in the Brilliance listing were keenly aware of an important exception to the stringent listing requirements mandated by the Securities Exchange Commission (SEC) in the US—an amendment to the Securities act passed in 1990 to make it easier for European companies to issue stock in New York (Interview with former FFI manager 23 May 2013; Chen 2013). The bankers of Credit Suisse, seeking to broaden their international client base, sought to do the same for their Chinese government clients that they had done for their European clients in the 1980s. Crucially, the listing

...would not have been possible but for a crucial regulatory platform structured by Rule 144A and Regulation S under the U.S. Securities Act of 1933, as amended (the “Securities Act”). Rule 144A and Regulation S are two exemptions granted by the U.S Securities Exchange Commission (“SEC”) in 1990 to exempt securities issuers from full compliance with the Securities Act, thereby allowing these issuers to access the global and American capital markets without going through a time-consuming registration process. (Chen 2013, p. 9)

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<sup>32</sup> The legal structure that was devised by Credit Suisse and their lawyers is far too complicated and nuanced to merit a detailed discussion. The Bermuda-based holding company did not actually control any physical assets, but given that in 1992 China had no law governing privatized assets a legal shell company needed to be created in a way that complied with US securities laws. The company was eventually de-listed and re-incorporated. For a more detailed overview, see Brilliance China 2013)

This was the first of 8 state-owned entities hand-picked by then-Premier Li Peng to raise capital abroad (Interview with FFI manager by phone, 23 May 2013). The experiment was to be part of the broader reform of government-owned enterprises, which were at the time essentially local government ministries, 120 of which were eventually chosen to undergo shareholding reform (Jeffries 2007). It was the beginning of a 5-year experiment with corporatization that would ultimately lead to a rush by Mainland SOEs to sell minority shares in stock exchanges abroad.

What role did foreign bankers play in all this? A complex explanation, which follows below, sees them as the intersection between global capital markets and China's bureaucratic compromise that created the contemporary system of National Champions, and the 1995 privatization strategy known as "grasp the large, let go of the small" (抓大放小). While it might be an exaggeration to say, as Walter and Howie (2012, chapter 6, para. 33) do, that "The New China of the twenty-first century is a creation of the Goldman Sachs and Linklaters & Paines of the world...", it is certainly true that without the likes of Henry Paulson and Carl Walter, and the increasingly sophisticated array of Hong Kong-based bankers looking to profit from China's double digit growth (Fung 2006), it is hard to imagine how the strategy of partial privatization could have been executed. This is largely because, as a simpler explanation would suggest, foreign investment bankers played a more modest role in the SOE restructuring process. Central government authorities and ministries like the PBOC spearheaded the restructuring, convincing domestic audiences (especially skeptics within the party) of the potential of partial privatization. FFIs were, in this arrangement, the salesmen in the partial privatization scheme: they sold the idea of international listing and corporate governance to high-ranking members of the CCP.

### *3.1 Domestic problems, International solutions*

Shortly after the successful Brilliance listing, Chinese authorities began to contemplate the prospect of selling foreign currency-denominated shares of corporatized state assets on the Hong Kong Stock Exchange (Fung 2006). At the time, as mentioned above, the city was still in the process of transitioning from a manufacturing economy to one dominated by services—especially, financial services. While China’s financial services sector was effectively decades behind that of the British colony that it was set to retake in 1997, Hong Kong was far from the financial services powerhouse that it is today. Moreover, the offshore holding company incorporation method employed in the NYSE listing could not be replicated in Hong Kong because the British colony did not, at the time, allow HKSE listings by companies located outside of Hong and Taiwan (Chiu and Liu 2009). However, in one of the earliest instances of Sino-Hong Kong official cooperation (Yang 2006), the two parties convened to arrange for Mainland companies to list on the HKSE (this refers to the consultations mentioned in the previous section). Officials from the latter visited Beijing to convince skeptical CCP officials of the possibility and advantages of Mainland companies listing in Hong Kong. As it turned out, listing requirements—increasingly stringent as they were becoming, following a series of reforms in the 1970s and 1980s—could be waived if the Hong Kong Register of Companies would approve of said companies’ legitimacy and permit them to list on the HKSE. To Beijing, especially in the context of the city’s return to Chinese sovereignty, this was an appealing prospect. In 1992, China lacked a law governing commercial enterprise (state-owned, or private), had no commercial dispute mechanism, and was only beginning to formulate securities regulations.

Discussion between Beijing and Hong Kong lasted nearly a year and on June 19, 1993, CSRC, Shanghai Stock Exchange (SHSE), Shenzhen Stock Exchange (SZSE), the Hong Kong Stock and Future Affairs Supervisory Commission, and the HKSE concluded a five-party Sino-Hong Kong Securities Supervisory Memorandum. In the lead up to signing the memorandum, the Hong Kong Stock and Future Affairs Supervisory Commission approved a series of HKSE guidelines that would accommodate SOEs seeking to offer shares in Hong Kong (Lo 1996). More than a symbolic moment, the June 19<sup>th</sup> agreement saw the convergence of three forces: Chinese reformers, who sought a way to experiment with corporatization, HKSE officials and investors, who sought a link the fast-growing China market, and local financial intermediaries seeking to profit from China's renewed drive to open its doors to the world, with Hong Kong increasingly seen as a gateway of accessing the hitherto closed China market (Paulson 2015; Chen 2013).

This was the birth of the 'H-share' asset class, marked by the first 9 corporatized state entities that would list in Hong Kong by 1994. Indeed, days after the signing of the Memorandum, Tsingtao Brewery—a company that dates back to China's colonial era—made its intention to go public in Hong Kong. The relative success of these listings was felt in both Hong Kong and Mainland China. For the former, Chinese listings were an important step to the Island becoming an international financial centre (Meyer 2000). Starting from the early 1990s, an increasing number of international investment banks began to locate and even headquarter their Asia operations in Hong Kong. Henry Paulson, for example, recalls the disadvantages of running Goldman Sachs' Asia arm out of Tokyo, and noted how China's H-share experiment made Goldman executives reconsider their Asia strategy altogether (Paulson 2015). To be sure, it would be unfair to say that foreign investment bankers alone convinced Chinese policymakers to restructure and corporatize state-owned assets and list the new corporate entities abroad. As the previous section makes it clear, the Brilliance listing and batch of the first 8 H-share listings followed on the heels of experimentation with creative incorporation and backdoor listings in Hong Kong—carried out by representatives of cash-hungry Chinese local governments operating in Hong Kong and smaller

securities companies in the city, eager to promote the new idea of red-chip shares. As such, without inferring too much, we can at least observe that there was a convergence of interests on the part of international bankers and reform-minded Chinese officials.

However, downplaying the role of foreign bankers in this regard would be equally erroneous. While the H-share experiment certainly showed the potential of raising capital and restructuring government ministries—the potential of “capitalist tools in socialist hands,” to borrow one of Deng Xiaoping’s most memorable phrases—Chinese officials were not convinced by the potential of organizational transformation and capital injections that would soon define China’s National Champions strategy. Investment bankers and accountants typically charge very high fees (sometimes in the hundreds of millions) for being underwriters and book runners in an IPO process. As Gillis (2014) has aptly demonstrated, many Chinese officials in the early 1990s were not impressed by the compensation rates proposed by investment banks and accounting firms—so much that many of these firms accepted payout at far below what they were used to just to establish lasting relationships with policymakers. Moreover, investment banking was a wholly new business to China’s governing elite who still needed to be convinced about the need for the likes of Merrill Lynch, Morgan Stanley and Goldman Sachs—let alone CITIC. Liu Erfei, a crucial interlocutor between Chinese authorities and global investment banks recalls, his early work for Goldman Sachs was often greeted with rebukes by officials: “You’re a banker, but you don’t take deposits and you can’t give me a loan? Why am I talking to you?” (quoted in Chandler et al 2006).

An investment bank’s role in an IPO of a company is crucial. Typically, investment bankers will not only advise firms on an IPO strategy—the when, where, and what (to disclose, and not to disclose)—but they will seek out potential clients that are ready to purchase the issued stock. They are also tasked with setting an appropriate price for the initial issuing: set the price too high, and interested buyers will back out; set it too low, and the firm receives less money than a higher price would bring in. But in China, the role of international investment bankers was even more important than in a typical public offering. As Walter and Howie (2012) point out, investment bankers were



effectively tasked with creating a corporate entity from the ground up. In the case of Brilliance Automotive or Tsingtao, what existed were government ministries, with assets like factories and distribution networks, but also in-house regulatory personnel (these were, essentially, government department with only limited autonomy) and social functions, like housing and healthcare. As Paulson (2015, p. 39) recalls,

Much of what we did in China in those early days was educational. We might as well have been running a school— indeed, at times it felt as though we were. Even as our bankers sought to build relationships and sniff out business opportunities, they conducted seminars and conferences, gave tutorials in which they explained the benefits of privatization, analyzed Chinese industries, singled out the companies that could be floated on overseas exchanges, and explained such technical details in the IPO process as due diligence, book building, and managing a road show.

Beyond this, the incorporation process was not, for all intents and purposes, privatization. Government assets were transferred into a newly created holding company that—albeit independently governed and tasked with profit maximization—was ultimately answerable to policymakers at the top of the CCP echelon of power. Foreign bankers were tasked with selling shares of a company investors would ultimately have little control over. Moreover, Hong Kong-based investment bankers and retail investors had a more intimate knowledge of China and needed something much more tangible than what Brilliance Automotive was offering. Fortunately, Goldman’s China team, led by Henry Paulson, Liu Erfei, and Mike Evans, figured out how to make this happen, and in doing so created a model to be followed in subsequent restructurings of state-owned assets, which would give rise to modern corporate giants that populate the Forbes 500 list. Moreover, it set off a rush of Chinese enterprises seeking to list minority shares abroad, with a

whole host of political and economic implications to be elaborated below. That model was China Telecom—later renamed China Mobile.

#### 4.0 The China Mobile Listing

In 1996, Wang Qishan, then head of China Construction Bank first approached Goldman Sachs executive Henry Paulson with an idea of having the investment bank restructure China's nation-wide mobile telecommunications assets into a corporate entity and float the corporatized shares on international stock exchanges, in Hong Kong and in New York. Paulson (2015) recalls being surprised by the offer. After all, CCB was the Chinese partner in the China International Capital Corporation (CICC)—the Sino-foreign investment banking joint venture with Morgan Stanley (the same strategy employed in the automotive sector—see Chin 2007). Why would Wang's team pass on their business partner and approach another bank to lead the corporate restructuring and IPO? Why was Goldman Sachs approached in the first place? As late as 1996 (one year prior to the China Mobile listing), its presence in China was quite limited and substantially lagged behind that of other American and Hong Kong banks (Paulson 2015). As it turned out, the reasons had as much to do with politics as with Goldman's credentials to take the future China Telecom public. For foreign banks, the cooperation with Chinese authority was often about a simple process of quid quo pro: the bank would transfer financial product and management expertise to the Chinese partner and the latter would, in turn, open doors for the former in terms of business opportunity in China's financial services market. But the Chinese side simply did not see the emerging partnerships in this light: for Zhu and other reformers, foreign bankers would be given the privilege of profiting from China's reforms in exchange for being on board with the policy goals set forth at the State Council level of the CCP.

As mentioned above, CCB was a majority partner with Morgan Stanley in a joint venture to pilot an investment banking business in the Mainland. The CICC was, as the next chapter will demonstrate an important strategic move for Morgan Stanley and for foreign investment banks more generally. The FFI community was anxious to see how Chinese state banks, and ultimately the Chinese government, would react under joint venture partnership terms—especially as Morgan Stanley was a minority partner (Interview with FFI manager in Beijing, May 16 2013). As it turned out, the domestic and Chinese partners each had their own ideas about the purpose of the arrangement. The Chinese side in the partnership side was anxious to learn about investment banking and financial products from their foreign partner. Morgan Stanley, however, wanted to co-manage the operation and exercise significant agency with respect to business strategy and managerial control. The two did not see eye to eye on this matter and relations between them quickly deteriorated. But why did Zhu<sup>33</sup> choose to approach Goldman and not, for example, a Hong Kong Bank? After all, Zhu Rongji was anxious to prove the CCP's goodwill toward Hong Kong as the 1997 handover was looming and many residents of the city (including the business community) were uncertain about how the business climate would be affected after a handover.

In part, Goldman may have been approached for many of the same reasons that saw American investment banks dominate the lead positions of the early listings of Chinese SOE and state bank IPOs: US banks' experience with helping companies go public was perceived by the Chinese to be the most extensive; American financial expertise was seen to be the most *xianjin*, (先进)—the most advanced in terms of financial services expertise. But beyond this, Zhu was spending much of his political capital on leading China to join the WTO and may have been keen to deal with American bankers, given the ongoing negotiations on PNTR talks with Washington. Regardless of the reasons, American bankers dominated underwriting and advisory roles of the big SOE IPOs through the mid-2000s (see Walter and Howie 2012, chapter 6, table 6.6). Moreover,

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<sup>33</sup> According to Paulson (2015, p. 8), Wang made it clear that they approached Goldman on Zhu's direct orders.

because Wang Qishan's idea involved a simultaneous listing in Hong Kong and New York<sup>34</sup> an American bank seemed like a natural choice.

Equally important, Goldman's IPO pitch may have worked because the bank's experience with restructuring and listing the shares of former German telecom ministry assets resonated with Zhu's goals for the Chinese state-owned sector. As Paulson describes it, "the IPO had raised \$13 billion, financing the development of telecom industry infrastructure, particularly in the former East Germany, the once Communist state. The deal had strengthened Deutsche Telekom domestically, made it competitive in the vast international market, and allowed it to take care of pension and medical insurance costs for retired and redundant workers" (Paulson 2015, p. 10). In other words, if Goldman would achieve even a fraction of the success of the Deutsche Telekom deal, it would pave the way for achieving a number of goals of China's SOE restructuring process, including the trickiest aspect of SOE privatization: providing for the wages and retirement of workers that would inevitably be deemed to be 'redundant' and be laid off. As Paulson summarizes his experience:

Initially, I had my reservations about this audacious plan, which was a bet on China's future. What if China didn't continue with asset injections from the other provinces? Investors would have bought into a hollow promise. But I realized that the Chinese had no choice but to follow through. They wanted foreign know-how, they wanted capital, and they wanted other state-owned enterprises to be able to come to market as well. China Telecom (Hong Kong) would be the lens through which the world would view China and decide whether its big companies

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<sup>34</sup> This would not only raise more money than a Hong Kong-only listing, but would show that American capital markets could also be tapped in a significant way—as opposed to the under-the-radar and small-funds raising approach taken in the Brilliance China listing. As Zhu was increasingly pushing the rhetoric of 'linking up with the international track' (Wang 2007) and pursuing China's WTO membership, a global cross-listing would have not only have provided a symbolic victory, but would no doubt give Zhu more political clout to pursue WTO membership (Lampton 2002).

could become competitive, well managed, profitable, and thus worth investing in. The Chinese would do what it took to make this deal a success (Paulson 2015, p. 56).

#### *4.1. FFIs at the Intersection of China's Industrial-Financial Complex*

China's industrial and financial restructuring process has been examined in detail in a number of studies focusing on the SOE sector (Nolan 2001; Nolan and Wang 1999) as well as the financial sector (Heilmann 2005b; Green and Liu 2005) and need not be revisited here in detail. However, few existing studies even mention, let alone acknowledge the important part played by foreign investment banks in this process. Chen's (2014) study of the CCP's intra-party debates regarding industry restructuring and consolidation, however, goes some ways to indicate the potentially transformational role played by FFIs. Chen outlines in great detail how intra-party debates throughout the 1980s and 1990s (with legacies and ideas for restructuring dating back to pre-Cultural Revolution era debates) saw influential party members put forward competing versions for privatization and industrial policy. Some factions within the CCP, skeptical of the ability of IPOs to raise enough money on a large scale and to sufficiently transform and consolidate commercial activity in China, suggested creating multiple and directly competing SOEs under a smaller number of state-owned holding companies. China Telecom's successful IPO effectively tipped the scales of the debate in favour of those who pushed for a 'grasp the large, release the small' approach:

Pioneering the rise of China's yangqi, the corporatization and flotation of China Mobile, Sinopec and CNPC on the eve of China's WTO entry demonstrated a possible path that giant state-controlled corporations with relatively modern

managerial and governance systems could be constructed in China in a relatively short period of time through a combination of the institutional legacy of central industrial ministries system, the leadership of communist party technocrats, the tactical use of the bureaucracy's administrative power, and the pragmatic learning-by-doing from the Western modern business institutions and practices. While there have still been intense and on-going debates, bargaining and bureaucratic struggles associated with the question on exactly how to define 'the large' to 'grasp', the overall approach of building a batch of large modern multi-plant oligopolistic firms under the central control has been remarkably consistent over the last two decades. By recomposing the existing centralized industrial order, the old system of bureaucrats in industrial ministries has been reinvented into one of bureaucrats in business, and indeed, in oligopolistic big business (Chen 2014, p. 76)

Goldman's interest in the deal was pretty clear. The reputational gains alone—leading the first multi-billion listing and restructuring of a Mainland Chinese enterprise—would be worth the effort. But the relationships cultivated with senior Chinese leadership—from Wang Qishan to Zhu Rongji—was far more than the icing on the cake. Paulson points out that success of the deal would prompt further international listings and earn international bankers the trust of the CCP leadership. As it turned out, cooperation with international investment bankers was, indeed, the way forward for the Chinese leadership to achieve financial and SOE reform. For the Chinese side, the success of the deal, hedging so heavily on the tactful maneuvering of (on Goldman's side) Henry Paulson and Mike Evans in the Hong Kong and New York financial community, and Liu Erfei in his experience with the Chinese bureaucracy, was potentially transformative at a time when China stood at the crossroads of centralization and de-centralization (Shih 2008). As discussions between

MPT Minister Wu and his counterparts in the Guangdong, Zhejiang, and Jiangsu provinces—those with the most developed and profitable mobile telecommunications networks—provincial leaders sought instead to keep their telecom assets in local hands; to establish a number of locally-owned SOEs, each operating within their respective provincial domains (Li 2012b). Skepticism to national incorporation was raised on a number of grounds, including national security issues relating to exposing national telecommunications to foreign capital (Li 2012b).

But the centralization proposal favoured by Wu Jichuan, Wang Qishan, and Zhu Ronji was ultimately given priority for a number of convergent factors that allowed Goldman’s team to insert itself directly into these debates. Henry Paulson and John Thornton were formally approached by Wang Qishan in 1997, and were given only several months to restructure MPT’s mobile assets and float the China Telecom shares in Hong Kong and New York simultaneously. As late as 1996, the idea of separating national telecom regulatory functions from the business of mobile communications—of incorporating the latter into a ‘national champion’—was only floated as an exploratory proposal by Minister Wu to his reluctant provincial counterparts. Wu rebuked both security and political concerns of his opponents by pointing to the long-term benefits of the centralization effort. Among these benefits, he noted the return of Hong Kong to Chinese sovereignty and the politics behind it, and the subsequent need to internationalize and grow the island’s economy, as well as the potential for industry modernization and the development of managerial expertise at home. He has been quoted in a telephone conversation, with a reluctant CCP official, as saying that the benefits would boil down “not just [to] financing, but [to] the process of modernizing corporate management... The overseas listing provides us with a great opportunity for enterprise reform” (quoted in Li 2012a; author’s translation).

However, given initial reluctance among other senior members of the CCP (Chen 2014), the proposals had to be executed in a rather flawless fashion (Paulson 2015). Success would help Zhu Rongji’s drive to internationalize China and to sell his other initiatives (including the highly contentious and high-stakes WTO accession talks) to a home audience (Paulson 2015). Moreover,

it would be a decisive victory for Zhu Rongji's Centralization drive (Shih 2008). One industry analysis of the China Telecom IPO (Farhoomand 1999) took notice of the very political nature of the listing, including the weak business credentials of the company's growth plans, as evident in the prospectus, and the lack of actual privatization of assets (foreign investors were completely barred from entering the Mainland telecom industry, save for a 2 percent strategic stake by Vodafone, which would only materialize three years after the listing anyway). However, whatever investors actually thought of the new company, it was rather clear that its attractiveness as a business was built quite simply on its role at the core of the centralization of China's mobile telecommunications assets, and the further centralization (Chen 2013), as well as the future centralizing asset injections that were promised (Walter and Howie 2012).

Indeed, part of the genius of the plan, cobbled together by Liu Erfei and Mike Evans on Goldman's side and Wang Qishan and Wu Jichuan on the Chinese side, was to arrange an agreement that would see provincial telecom assets integrated into the wider China Telecom holding company at an unspecified time after the listing, premising growth in profits on a promise of further bureaucratic reorganization (Farhoomand 1999). Essentially killing two birds with one stone, this put off some of the more difficult bureaucratic moves to a future date, while simultaneously publishing a complicated but appealing listing prospectus that promised investors return based on future profitable asset injections. But more importantly, what Goldman and their counterparts in China Construction Bank achieved was more profound than convincing investors in Hong Kong and New York. What Goldman began in 1997 was a model that would allow subsequent reforms to use global capital markets in a very important way. It allowed Chinese policymakers to use global financial markets to raise capital without facing important advisory, legal, and location obstacles that would have been apparent prior to the late 1990s.

Goldman's successful leading and underwriting of the China Telecom IPO was the beginning of what Chen (2013, p. 9) calls 'institutional arbitrage:'



Whereas traditional arbitrage is about individual market players taking advantage of information asymmetry and price differences between multiple markets, institutional arbitrage focuses on the way in which the developmental state and its affiliates leverage the complexity and differences between multiple systems of regulations across countries to pursue their development goals and/or carry out long-term strategies.

As Chen explains, after the IPO, Chinese policymakers began to understand that capital market development and capital account liberalization need not be a prerequisite to actually gaining access to global capital markets. More importantly, FFIs offered the Chinese government a way out of a very difficult dilemma: raising sufficient capital for restructuring SOEs and state banks, without lifting capital controls and without relying on domestic stock exchange. In the late 1990s, lifting capital controls was problematic not only for political reasons (the party was far from a consensus on the role of private financial capital in China's economy) but was generally an unattractive choice in lieu of the East Asian Financial Crisis and the troubled experience of East Asian economies like Taiwan, Thailand, South Korea and Malaysia, who adhered to IMF rules on capital flow. But restructuring SOEs and state banks without additional capital injections was difficult, given the looming problem of insolvency in China's state-owned corporate sector. While bad debt was quickly and unceremoniously removed from the state banks' balance sheets indefinitely to be held by the newly created Asset Management Companies (Chapter 6 will outline the process in more detail), it was not clear where new capital would come from (Walter and Howie 2012). Indeed, China would not become the biggest member of a new class of high-saving, capital-rich emerging market economies that US Fed Chairman Ben Bernanke would later deem responsible for creating a "global savings glut" (Bernanke 2005) for nearly another decade. So where was the money going to come from?

One option was China's own citizens, who had little choice aside from the banking system as a source of savings and personal investment. This money could be used to finance further SOE borrowing and bank recapitalization. However, given that much of their money was already sitting in savings accounts in the Big Four state-owned banks (Pettis 2014), there was little that China could do to increase borrowing through this channel in the short run. The fast-growing domestic stock and bond markets were another option. However, throughout much of the late 1990s and early- to mid-2000s, much of the money available through this channel was state-owned capital anyway, and private pools of capital were still too small to create a sufficient new source of financing (Walter and Howie 2012). Thus, listing Chinese stocks on foreign exchanges was, at the turn of the millennium, a crucial lifeline for the restructuring of China's corporate sector (Chen 2014). However, issuing publicly traded shares on global stock exchanges was tricky. It required balance sheet and revenues disclosures that would, and did (e.g. United States Congress 2005), make foreign regulators suspicious. As noted above, FFIs leading Chinese SOE IPOs were able to convince investors (most importantly, other institutional investors) across the globe to buy share of Chinese companies that were premised on promises of future growth. However, foreign regulators were less receptive than foreign fund managers to these listings. (Chen 2013) For instance, in 2003, China Life Insurance's New York Stock Exchange IPO was singled out for disclosure irregularities, making further public listings in the city a controversial matter (Walter and Howie 2009)

But much like Hong Kong-based FFIs, who in the early 1990s worked with the city's regulators to attract Chinese state-owned firms to raise capital there, American banks were quick to find a solution to this legal problem as well. Starting in the early 2000s, FFIs were increasingly becoming indifferent to the location of the assets they were buying. Improved communications technologies and the globalization of finance more generally meant that FFIs who wanted to invest in Chinese companies (and the appetite to do so was growing rapidly) simply needed to find jurisdictions with more favourable listing requirements. Indeed, not only Chinese policymakers but policymakers across the developed and emerging economy landscape across the world took notice

and began to compete for Chinese firms to be able to list in their jurisdictions. Naturally, Hong Kong was the first to take advantage (Chen 2013), but Luxembourg, Singapore, London, and other global cities soon joined the competition to attract Chinese companies to list. Moreover, different legal frameworks across different global jurisdictions gave Chinese firms a number of options beyond public listings. Private listings, where shares would be issues to a select number of FFI fund managers, often precluded the need for a lengthy and complicated public offering (ibid; see Chen 2013 and Gillis 2014 for a more detailed legal discussion). Simply put, financial globalization meant that as long as foreign banks wanted to invest financial capital into Chinese state-owned firms they could find a way and place to do so.

In this context, 2005 became the year that China's spatial internationalization went global. On September 26 of that year China Construction Bank rolled out its Hong Kong listing, with a total value (\$472 HKD) that was three times greater than the pivotal BoCom listing discussed above. The Chinese government distributing only 12 percent of its 72 percent ownership in the bank, with Bank of America and Temasek holding another 20 and 6 percent, respectively (Horne 2005). This was followed by the international listings of the other 3 of the Big Four, with ICBC and ABC setting global IPO records, raising at \$19 billion USD and \$22 billion USD, respectively (Bremner 2006; Bloomberg 2010). Each of these deals was underpinned by the large minority stakes taken by FFIs, with a two to four year lock-up period, assuring global investors that FFI managers were willing to back up their sales pitch to global investors with their own cash. Over the years, these were followed up by the listings of other, smaller joint-stock city and provincial commercial banks (mainly in Hong Kong).

The key characteristic of these IPOs was that the listed shares were minority shares, with typically no more than 15 percent of the company offered to the public. In these listings, a foreign bank (or multiple banks) would underwrite the offering, and organize a consortium of banks to support the public offering by purchasing shares. The government would remain the majority

shareholder by purchasing non-transferable shares<sup>35</sup> of the company in on the Shanghai Exchange (see Gillis 2014 for a detail overview of the legal and procedural details).

It was noted in chapter 3 that FFIs have, with the important exception of their role in China's WTO accession, seldom lobbied cooperatively. Investment bankers' role in helping Chinese companies raise money overseas has made this obstacle—from a lobbying and market access standpoint—an especially inexorable one. In this instance commercial and investment banking interests were almost diametrically opposed. From a commercial banking standpoint, the goal was surely to open China's domestic banking markets to foreign competition by, among other things, removing the barriers to foreign ownership and other systemic barriers explored in the previous chapter. But from an investment banking standpoint, one could almost argue that this would be harmful to their interests. If China had followed the route of many post-communist economies and opened their financial sector to foreign ownership and competition, there would not be the same urgency to rush to global stock exchanges to raise capital for the ailing SOEs and banks. In other words, investment bankers' success, as the next chapter will show, was the commercial bankers' failure. From the CCP's point of view, they no longer needed FFIs' capital; only their expertise, which—as we will see—in the political-economic environment created by the SOEs and banks' offshore listings, was easy enough to acquire, and precluded the need for the CCP to retreat from playing a role in China's financial system. As the next section will show, the important role of helping insolvent Chinese state-owned financial institutions raise capital abroad to fund institutional restructuring, and to avoid privatization, continues to this day.

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<sup>35</sup> See Walter and Howie 2009 for a detailed discussion of non-transferable shares. Many of these shares were eventually made tradable but the government, via SASAC or the Ministry of Finance (or, as in many cases, municipal and provincial governments would also hold shares of their respective banks), remained the majority shareholder.

## 5.0. Looking Ahead: Strategic Equity Investments and Offshore Listing of China's AMCs.

China's Asset Management Companies (AMCs) do not resemble commonly understood asset management firms that exist both inside and outside of Mainland China. They do not manage pooled capital in the form of mutual funds or exchange-traded funds. Quite specifically, the AMCs were formed as part of a set of banking system reforms approved by the State Council in 1999 that would see bad debt transferred from the Big Four state banks to one respective holding company for each bank. Four AMC were initially set up included Cinda (for China Construction Bank), Great Wall (for Agricultural Bank of China), Huarong (for ICBS [Industrial and Commercial Bank of China]), and Orient (for the Bank of China). The AMCs were to take the bad loans off the balance sheets of the banks with the intent of resolving the banks' non-performing loans (NPL) problem. The issue of mounting NPL ratios on China's financial institutions' balance sheets was demonstrated by the collapse of GITIC, a Guangdong-based trust company whose lost assets seemed so vast and opaque as to make the company irredeemable (a subsequent KPMG-led investigation also found that the company faced daunting insolvency). Speculation from the investment community that the rest of China's national financial champions faced similar problems prompted the creation of these novel (in China) institutions to deal not only with run-away lending practices, but also to expose China to international financial markets. With NPL assets taken off the banks' hands (Steinfeld 2005), and with a number of other important measures to clean up the banks' balance sheets, including earlier re-capitalizations by the PBOCs, implicit guarantees from the Ministry of Finance (Shih 2008), and a complete overhaul of the banks managerial structure and labour force (with thousands of branches closed and personnel laid off) (Steinfeld 2010), China's financial institutions were able to issue successful IPOs in Hong Kong and New York.

Foreign banks were an essential part of this plan: from advising authorities on how to set up the AMCs themselves (they were modeled on the Resolution Trust Corporation that cleaned up bad debts in the US financial system in the 1980s and 1990s), to the eventual restructuring and

listing of the banks years later. In 2000 a total of RMB1.4 Trillion (US\$170 billion) was transferred from the banks to the AMCs. In 2004, a further RMB1.6 Trillion (US\$198 billion) was transferred to the AMCs, including a portfolio of RMB603 billion from smaller financial institutions (Walter and Howie 2012, pp 56-58); they also assumed the debt obligations “of a host of bankrupt securities, leasing, finance, and insurance companies and commodities brokers” (Walter and Howie 2012, p. 74). From the beginning it has been very unclear how the burden of NPL disposal would be borne, let alone *who* would bear it. The plan was presented to the media as a private equity restructuring scheme, whereby the AMCs, as private equity managers, would take the loss-making firms, consolidate and streamline their operations (the loans were restructured into equity), and sell off the companies to international investors. However, while restructuring would surely involve a write-down on the value of these assets, with optimistic initial estimates of somewhere in the range of 30-50% (Shih 2008), the institutions, oddly enough, appear to be charged with recovering the full value of their assets (Steinfeld 2005, Walter and Howie 2012).

And indeed, Steinfeld (2005) has noted that the managers of Xinda, Huarong, Changcheng, and Dongfang were operating under the directive of (somehow) recovering the full value of their entrusted assets. How exactly was this intended to happen? How would the banks, the MOF, and the PBOC make up the difference inherent in the AMCs asset write-downs?

While it is difficult to find a plan in place that would help us to illuminate the actual policies of Chinese policymakers with respect to the AMCs, the strategy that has been adopted is not at all unlike previous strategies to develop the domestic financial sector, and foreign bankers’ response has followed the previous pattern that can be observed with respect to their participation in state firms’ IPOs. Some have suggested that the aim of Chinese financial authorities has been to resolve bad debts by raising capital abroad—with the essential explicit consent and seal of approval from foreign financial institutions to lead the underwriting process and to themselves participate in the listing as (pre-IPO) strategic investors and IPO subscribers (Walter and Howie 2012).

At the end of 2006, China Huarong Asset Management Corporation (Huarong AMC) announced that it had completed “handling” its NPL assets (Xinhua 2007). Not surprisingly, the loan recovery rate, just shy of 18 percent, is far below that which was claimed in the original plan. So how does the AMC plan to balance its books, having recovered not a fifth of its assets? According to its president at the time, the plan is “to develop into a modern financial corporate group which provides financial services including asset management, investment banking, financial lease, warranty and trust businesses” (Xinhua 2007). This plan began to take root in the Spring of 2012 when one AMC, Cinda, attracted strategic investors in preparation to move toward an IPO. On March 16<sup>th</sup> 2013 Cinda decided had successfully attracted two foreign players, UBS and Standard Chartered, to buy strategic shares (meaning they would be locked up for several years) along with CITIC Capital and National Council for Social Security Fund (the state-owned pension fund). Roughly one year later, the chairman of Huarong Lai Xiaomin announced that twenty foreign financial institutions were interested in investing in the financial conglomerate as it prepared to restructure in order to list in Hong Kong sometime in the coming two years (Ruan 2013). Soon after, Deutsche Bank, Goldman Sachs, and Morgan Stanley announced their interest in what is believed to be an upcoming \$1.5bn IPO by the firm (Purkayastha 2013). Around the same time, Great Wall and Orient suggested that similar processes might be involved in their restructurings in the coming years (Ruan 2013).

Cinda has been the first to proceed to an IPO, with Bank of America’s Merrill Lynch unit, Credit Suisse AG, Goldman Sachs, and Morgan Stanley handling the underwriting process. It is reported that 44 percent of the \$2.46bn it seeks to raise in its IPO has been subscribed by investors ranging from Norway’s sovereign wealth fund, to US-based Distressed-investment specialist Oaktree Capital Management (South China Morning Post 2013). Debates surrounding the business of distressed debt management aside, it is far from insignificant that foreign financial firms have been so heavily involved in these deals. Two implications can be proposed here. First, China’s decision to list the companies abroad suggests that foreign firms have their last chance to make a

mark on how China liberalizes its financial sector. As the Shanghai FTZ unrolls without their direct participation, and as large state banks continue to dominate domestic markets<sup>36</sup> the remaining space for their expansion is limited. The AMCs' foray into raising capital abroad represents the latest (and perhaps last) example of their strategy of bridging China's with global financial markets. As such, a second implication follows. The foreign financial sector—in particular, European and American international bankers—are taking every possible measure to ensure that China's financial sector does not take the route of its counterparts in energy or telecommunications, where state-owned firms shut out virtually all competition. They remain useful to authorities as China's growing link to global capital markets, allowing the Chinese state to enjoy both the fruits of protectionism (in the domestic banking sector), as well as that of liberalization via the listing of its financial and non-financial 'national champions' abroad.

In many ways, the reporting of the loan recovery rates seems unnecessary, as the original goal of unloading problem assets to global markets exists largely as a historical artifact. What matters today is their ownership and management of financial entities, which include a variety of failed private sector entities—and not just insolvent SOEs acquired after the fallout of the Asian financial crisis. The AMCs currently hold licenses to conduct financial transactions, such as insurance, commodities brokerage, leasing and securities trading, which they acquired when they assumed control over a large number of bankrupt private companies in 2005 and 2006<sup>37</sup>. Indeed, as is often the case in China, the AMCs showcase the proliferation of market-based norms and instruments, such as recent experimentation with complex financial derivatives by the AMCs (Interview with FFI manager by phone, 23 May 2013)), alongside the maintenance of direct

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<sup>36</sup> Currently, privatization in the retail banking and securities sectors is gaining momentum, but largely through private firms in China establishing their own banking operations. And even here, regulators are quite weary of anything approaching rapid expansion. Limitations on banking services introduced by firms like Baidu have been common (Wildau 2015).

<sup>37</sup> These firms include a wide-range of financial entities, including credit-rating firms, securities-trading firms, insurance, trust and fund-management companies, and even real-estate development and hotel-management firms (Walter and Howie 2009, p. 75).



government shareholding and policy directives, such as the case with Orient AMC's commitment to "maintaining the social stability and constructing a harmonious society" (China Orient AMC 2012). Foreign banks' business strategy steadfastly holds to carefully navigating this dual-track policy of liberalization and protectionism. Allowing them to participate not only in the market-based initiatives, but in the broader social project of the CCP as well.

The AMC case also goes some ways toward illuminating China's policies on equity market development, throughout the period surveyed in this study (1990 to 2012). It certainly appears that between 2005 and 2012 the Hu/Wen government's policies in this regard have conformed at least in part to Walter and Howie's (2012) hypothesis that financial reform had effectively stalled from 2005 onward, and that the Zhu Rongji-engineered compromise—first relying on foreign equity markets for financing and concentrating on domestic equity market development thereafter—had been postponed at least for the duration of the Hu/Wen tenure. As such, FFIs have, during this time, continued to play the role of helping Chinese policymakers to indefinitely put off at least some aspects of financial sector reform—notably, making domestic stock markets an effective avenue to raising funds and ensuring corporate governance oversight. This also conforms to Nolan's (2010) conclusion regarding corporate governance reforms in Chinese state-owned financial institutions: that having foreign investment banks purchase 'strategic' stakes in Chinese financial institution has been, at least in the 2005-2012 period, more about gaining international legitimacy than about genuine reform in these institutions. In this respect, the government's policy regarding domestic stock market development in this period is unlikely to have been to make Shanghai and Shenzhen's exchanges reflect Anglo-American ones in principle and in practice. However, the precise nature of the Hu/Wen model for domestic stock market reform remains unclear.

## 6.1 Conclusion

This chapter has examined the internationalization of China's equities markets. The goal has been to demonstrate that FFIs played an important role in the process. It has shown how FFIs were able to help Chinese policymakers achieve a number of important goals in China's financial evolution. First, they played a key role in the growth of Hong Kong as a global financial centre and an offshore point of access for foreign investors seeking to make financial investments in China's state-owned enterprises. It was not long before other global financial centers joined in, and began to attract global capital by inviting Chinese firms to issue stock in their respective jurisdictions. Second, they helped Chinese policymakers to leverage access to global capital markets without having to relax capital controls. This was a very significant achievement for Chinese policymakers because it not only allowed them to raise new capital for the development of the country's new 'national champions' (i.e. it allowed them to finance the centralization of state assets) but also helped them to expose SOE managers to the oversight of international banks, making them profit-oriented enterprises, without privatizing them. In this regard, this chapter explored the key role played by Goldman Sachs in the landmark China Telecom IPO. It showed how the listing happened at a pivotal moment in China's financial transformation, helping Zhu Rongji to push forward his agenda for financial reform against a conservative opposition that consistently warned and pushed against creeping privatization in China's economy. It allowed China to access foreign capital without ceding managerial control to foreigners and before its domestic financial markets were 'mature' enough to provide SOEs with new channels of financing.<sup>38</sup>

The findings and analysis presented here should not be interpreted as showing that FFIs played the *most* important role in China's financial transformation. Chinese policymakers, as well as policymakers in Hong Kong, and local securities firms, were the drivers of many of the changes

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<sup>38</sup> This is not to say that China's capital markets are 'mature enough' today to efficiently link investors with the capital needs of Chinese firms. Rather, this hypothesis suggests that FFIs' involvement with SOE overseas capital-raising allowed Chinese policymakers to postpone resolving the issue of stock market efficiency into the future. Walter and Howie (2012), for example, argue that policymakers have continued to postpone the issue and never came around to addressing it—but this is a debate that reaches well beyond the scope of my research.

described in this chapter. In this respect, FFIs essentially piggybacked on existing trends in Hong Kong. But this does not diminish the importance of their role: taking these local trends to a global level—essentially, helping to globalize the listings and concomitant restructuring of Chinese SOEs.

Specifically, beginning with Goldman Sachs, FFIs acted as channels connecting global financial capital to the financing needs and reform strategies of the CCP. They helped to internationalize China's financial sector before it underwent domestic liberalization. They helped to create and spatial linkages between Chinese state enterprises and global investors, starting in Hong Kong, and expanding to other jurisdictions like New York, Singapore, London, and Luxembourg. It has shown how their limited role in China's domestic financial markets belies their very significant contribution to the changes that the Chinese financial system underwent in the 1990s and early 2000s.

FII learned the importance of Hong Kong as a gateway to China and brought the money that made it attractive for Chinese companies to raise capital in the city. The conscious effort of Hong Kong regulators to attract Chinese companies to list in Hong Kong, coupled with the proximity of the island and the keen appreciation on the part of its financial professionals of the reform process and politics in the Mainland, made it especially attractive for FFIs to use the city as a base of their China operations. More importantly, the past and potential revenues realized from helping Chinese companies raise money in the city effectively put them on the same side as Chinese policymakers who saw a way to placate domestic resistance to privatization, while at the same time creating a group of SOE 'national champions' that would be able to compete at the global level. The next two sections explore in more detail how FFIs successfully latched on China's SOE reform process and helped the CCP leadership in the late 1990s realize a crucial goal: restructuring state assets and raising sufficient capital for this restructuring.

## Chapter 5: FFIs' Role in Transferring and Localizing Anglo-American Expertise

### 1.0 Introduction

This chapter will explore the ways in which FFIs have transferred Anglo-American financial expertise to their Chinese counterparts. This will allow me to better explain the 'systemic' obstacles that have prevented FFIs' important role in China's financial evolution from translating into greater freedom to conduct business on the mainland. Looking back at chapter 3, we see that lobbying in the post-WTO accession has not been particularly fruitful, despite the easing of regulatory restrictions to FFI entry after the accession phase-in period, which ended in approximately 2006. Chapter 4 has demonstrated how global investment banks' role in creating overseas markets for Chinese equities postponed the need for more efficient capital allocation in domestic equity markets—thus keeping China's financial system a predominantly-bank based one, and precluding the need for greater FFI participation. However, chapter 4 only addressed stock market development. This chapter looks closer at four financial sub-industries: commercial banking, investment banking insurance, private equity (PE). It shows how FFIs partnerships with Chinese firms successfully transferred and localized Anglo-American financial expertise; and how this transfer of expertise ultimately contributed to the declining need for greater foreign participation in the Mainland financial system.

Section 2 recaps the narrative outline in the introductory chapter, but changing the perspective to give us a better understanding of the government's policy toward FFIs. The aim here is to show FFI strategies fit into what is understood to be the government's strategy towards FFIs over the past several decades. Section 3 examines FFIs' joint ventures (JV) and strategic partnership between FFIs and Chinese financial institutions. Section 4 looks at the more distinct case of private

equity, where the entry of foreign firms effectively sparked the creation of a brand new industry. Section 5 then briefly addresses the extent to which FFIs' transfer of expertise has been internalized by the Chinese financial sector.

This chapter showcases the irony of the ways in which FFIs have influenced the direction of financial reform in China and the obsolescing bargaining position that had emerged for FFIs by the end of the WTO phase-in period (the mid-2000s). By relying on returnees trained in the Anglo-American model of financial management—the favoured model among policymakers in China between the early 1990s and until the 2008 global financial crisis—to successfully create linkages between China's domestic financial system and global financial capital and practices, FFIs allowed domestic Chinese firms to prosper at the FFIs own expense. The former successfully leveraged the growing pool of returnees, helped along by China's priority of attracting overseas Chinese students to return to the Mainland, as well as Chinese firms' advantage in operating in a system defined by capital controls and inadequate financial transparency. As a result, the successful transfer of foreign financial expertise to the mainland—a significant way in which FFIs have influence financial reform in China—FFIs have inadvertently created favourable conditions for domestic players to dominate the market.

## **2.0. Recap and background: FFIs in China from the CCP's perspective.**

Before delving into discussing FFI strategies, it is useful to recap the narrative outlined in the introduction, but from the perspective of the Chinese government rather than from that of the FFIs. The aim of this section is to contextualize FFI-Chinese institution partnerships that will be discussed in subsequent sections into the government's broader strategy with respect to their role in China's financial evolution.

US investment banks, in particular, have played a crucial role in helping China to modernize its large oil and telecommunications giants largely by advising policymakers in China on how to build a modern corporate sector, with market-based accounting practices, stock market listings, and bond issuances. As Walter and Howie describe the process:

At the start of the 1990s, all Chinese companies had been unformed state-owned enterprises; by the end of the decade, hundreds were listed companies on the Hong Kong, New York, London, and Shanghai stock exchanges. In those few short years, bankers, lawyers, and accountants had restructured those of the old SOEs that could be restructured into something resembling modern corporations, then sold and listed their shares. (Walter and Howie 2012, chapter 1, para. 9).

In what Steinfeld (2010, p. 33) describes as “the transformative power of overseas listing”, Chinese state-sector managers learned from Western banks not only how to implement Western-style corporate governance practices, but also how to communicate with overseas investors and with the wider array of actors in the global economy. As Walter and Howie (2009) note, restructuring state firms was a painstaking process of virtually creating corporate entities that, at least in principle and basic structure, resemble Western corporations. This was a very key point of entry for foreign financial institutions: the building of markets, almost entirely from scratch. Much as recounted by Greenberg (Greenberg and Cunningham 2013), foreign insurers’ sales pitch was the creation of domestic insurance markets and the benefits thereof. For the banks, however, the task was even more grandiose: the privatization of government entities, some of which were basically governmental departments.

In this respect, the interests of foreign financial actors and those of Chinese policymakers and state sector managers were relatively aligned. The challenge for foreign banks, however, was to convince not Chinese policymakers of the reforms, but rather global markets. In this context, it

is important to ask how such *apparent* absence of bargaining dynamics has influenced the strategies employed by foreign banks in leading the privatization and listing of state firms. As Chin (2010) as well as Steinfeld (2010) have shown, the relationship between China's policymakers and multinational corporations needs to be placed in the context of the host country bargaining power. Steinfeld (2010) has shown that in many respects, China has gone a long way to adopt international norms as well as to cede control of important loci of economic activity in manufacturing to global firms largely because the benefits offered by integrating one's economy into existing global supply chains could not be realized without, sometimes ceding entire sectors to foreign control.

Chin, by contrast, has shown that, in the case of the auto industry, China has been able to form partnership with foreign firms on very favorable terms. With the use of the 1994 Automotive Industrial Policy to exact specific concessions from MNCs, China was able to bring leading automakers and establish foreign facilities and joint ventures on their own terms, achieving their previously failed attempts at localization by convincing leading MNCs of the value of establishing in China (Chin 2010). These two studies, not to mention many others (see, for example, Pearson 1992, Zweig 2002) point out that firm-government bargaining dynamics are important to explaining the degree of foreign involvement in a particular sector. Many important factors must be considered when assessing the strategies of foreign firms in China, including the level of coordination between local and central governments, the extent to which foreign expertise are needed to achieve a particular policy goal, and the extent to which China is seen to be necessary by particular foreign firms to their global operation. The financial sector in China provides an interesting addition to previous studies because, while these variables certainly played a role in the evolution of financial reform more broadly (see, for example, Green 2003; Shih 2007), there is little evidence of conflicting interests between the foreign bankers and their counterparts in the CCP. Both wanted to achieve the same thing: the raise capital in Hong Kong or New York. The more difficult question was how to do this while keeping the Chinese state in effective control of these corporations.

The real tug of war happened not between policymakers and foreign players, but between the banks themselves, who scrambled to participate in Chinese state firms' landmark 'privatization' from the late 1990s through to the mid-2000s. The government had set to create new corporate entities by bundling various provincial and central government ministries and state firms and enlisted the help of, by then, well connected bankers to sell these new entities to international markets. In those early days, *guanxi*—informal networks of contacts that plugged foreigners into China's markets through personal trust, rather than through money or credentials—was crucial. The key players were, for the most part Americans:<sup>39</sup> notably Goldman Sachs, Morgan Stanley, Merrill Lynch, and Citigroup, as smaller players like Bear Stearns. To get these deals the banks hired the so-called *princelings*, children of the most established party members (many from the pre-PRC revolutionary era).<sup>40</sup> This strategy was, by all measures, the most successful strategy that foreign financial firms have employed in China: Chinese state monopolies were restructured and sold shares in Hong Kong and New York—indeed, Chinese firms now represent a greater share of all other international firms on the HKSE (Walter and Howie 2012).

In this respect, the needs of the Chinese state and those of the foreign bankers were rather well aligned: both central and local government were looking to introduce efficiencies into the SOE sector—whatever principles or incentives this need for efficiencies entailed (at the very least many enterprises were a drain on provincial and municipal resources, which were severed from the financial guarantee of the central government by the early 1990s). At the Third Plenum of the Fourteenth Party Congress in 1993 the CCP adopted the policy to create a “modern enterprise system.” However, privatization still remained a sensitive topic among senior CCP officials, many of whom saw incorporation as a “Trojan horse for Western-style privatization and resisted it

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<sup>39</sup> One task while in Beijing: try to find out why the Americans outdid the Europeans in being awarded the contracts to restructure and list state firms.

<sup>40</sup> See, for example, Sender and Mitchell (2013), who describe the ascent of the first princeling—the daughter-in-law of former Premier Zhao Ziyang—as she was hired by Bear Stearns to chase some of these early IPO deals. A more detailed discussion of the role of princelings follows below.



fiercely” (Green and Liu 2005, p. 18). It was not until 1997, when the central government began to push for a shareholding reform in earnest, following a number of attempts to reform state enterprises without effective incorporation, without employing corporate governance models from abroad. China’s first attempt at endogenously directed privatization in the 1990s had produced lackluster results. Anything resembling the privatization of listed firms did not occur: instead state-entities were able to raise funds and to further retrench existing corporate governance models, leaving much of the old incentives in place (Green 2005, p. 125).

One pillar of the attempt at privatization came gradually with the gradual acceptance of the sale of SOE shares (in Shanghai and Shenzhen) to private investors (Green 2005). Another one, as documented by Liu, and Pei (2005), came as local governments sold off their assets by incorporating and selling state firms to managers and employees of the firms themselves. In both cases attempts at privatization, however, it became clear that many of the desired effects of the authorities in charge of privatization (if these are judged by various Third Plenum decisions made throughout the 1990s and early 2000s, as well as by CSRC speeches and official documents), did not pan out as planned; and in no small part was this due the tendency of domestically-based privatization schemes to very mixed results with respect to forcing firms to change their behavior (Green 2005). However, much changed in March 2003, when the State Council established a new ministerial organ called the State-owned Assets Supervision and administration Commission (SASAC), which effectively centralized the country’s privatization strategy. As Green and He describe, the nascent privatization ministry was given the paradoxical task of privatizing states assets and expanding the reach and effectiveness of the state (Green and He 2005). While SASAC did not oversee all of China’s IPOs (financial institutions, for example, are under the supervisions of the CBRC), it signified an important effort on the part of the Chinese state to maximize privatization, while also maximizing indirect (regulatory) state control over the economy (Pearson 2005). Green and He (2005) describe, SASAC represents the government’s effort to ensure market

incentives are to bear on existing state enterprises, while at the same time preventing outright privatization of SOE assets inasmuch as economically viable.

How was the government to achieve this goal? The preferred method throughout much of the past decade and half has been overseas listing. As state firms were restructured, stripped of bad assets, and put up ‘for sale,’ authorities needed not only blueprints for how to achieve the goals of SASAC and other government organs in charge of the envisioned SOE giants (as noted above, domestically-rooted schemes and ideas proved largely unsuccessful), they also needed to sell them and their model to international investors. This is precisely where foreign banks—already in China and awaiting the green light to expand their business—proved themselves as a vehicle to carry this forward. Foreign banks have been willing participants in carrying forward the CCP’s goal of internationalizing the Chinese economy and its state firms in particular.

There are a number of reasons why foreign banks were ‘needed’ by China’s policymakers in the early 1990s. Following China’s experiments with domestic capital markets, policymakers were enthusiastic to list Chinese firms abroad not simply as a means of raising capital to fund state-projects. Walter and Howie (2009; 2012) have detailed the ways in which the Chinese state uses capital raised abroad to support domestic policy goals. However, while this logic might apply for Chinese state-owned banks, which fund China’s non-financial SOEs, it has less relevance for the listings of firms like Shanghai Petrochemical (later a subsidiary of Sinopec) and Tsingtao Breweries. As Green (2003, p. 37) has shown, the money raised by Chinese firms in capital markets pales in comparison to the funds they raise directly through the banking system. Likewise, the funds raised by state firms in the domestic A and B share markets still outnumber those raised in the H-share (Hong Kong) markets and those in the NYSE combined (Green 2003, p. 34). Moreover, the international dimension of the early listings was important because, as Paul Gillis (2014) points out, the normative changes that these listings would bring were essential for policymakers’ plans to change corporate governance incentive structures among state firms.

Gillis (2014) details how in 1992 major international accounting firms developed good personal relations with top Chinese leaders, like Liu Hongru (then securities regulator) and even Zhu Rongji. Policymakers were rather ambivalent about relying on foreigners to audit state-firms at the time. Along with complains made by domestic accounting firms, there was also a dearth of understanding among the firms and Chinese leaders themselves about how auditing works in practice. Gillis systematically shows how the Big Four have been able to establish ‘hegemony’ (in the Gramscian sense) in China’s accounting industry by convincing the Chinese government to acquiesce to their normative and institutional role in connecting China to international capital markets. Gillis’ narrative of the Big Four in China goes some way in illuminating the role of foreign banks in achieving something similar: creating the governance foundation of the newly-listed Chinese firms.

However, while the Big Four accounting firms have been able to become ‘hegemonic’ and also to hold on to a hegemonic role in China’s accounting and auditing industry vis-à-vis the CCP’s internationalization strategy, foreign banks have failed to do the same. While direct evidence is scarce on this disparity, we can nonetheless deduce three main reasons for the foreign banks’ failures. First, and as mentioned above, while the Chinese government did rely quite strongly on the banks’ technical knowhow and legitimacy to sell its privatization and corporate governance reform program to global investors, the number of competing actors in the global investment banking field far outnumbered those of accounting firms. Mirroring a story that continues to this day, foreign banks are so keen to enter China’s markets that inter-foreign competition actually reduces their market share and bargaining power relative to domestic actors. Second, unlike the services rendered by accountants, whose auditing is continually required by SOEs, restructuring and listing firms is a one-time service that requires no follow-up. After the first round of successful listings, the level of interest by foreign banks increased dramatically, further bidding down the bargaining power of international firms vis-à-vis the government (interview with financial journalist, 10 July 2013). This mirrors the findings by Chin (2010), who has found that once the

government finally put together a centrally-coordinated automotive strategy foreign firms could no longer ignore the market and entered into JV contracts with Chinese state firms on more favourable terms.

Third, and lastly, in order to understand why foreign banks have not gained a markedly important place in China's political economy following their crucial role in restructuring SOEs, we have to look closer at how China's various economic policy organs (most notably SASAC and the local government in Shanghai) link China's financial sector policy and its policy regarding the evolution and future role of the SOEs. For instance, we may ask why did the Jiang/Zhu government opt for international IPOs for the SOEs rather than domestic ones to restructure the SOEs? After all, Japan, Korea, Taiwan, and other East Asian economies channeled capital domestic and developed domestic equity markets before earnestly moving to internationalize their firms. And much like in these economies, domestic savings and, therefore, capital in China are abundant.

Why rely on international markets? As Green and He foresaw, "the government's ambition should not be underestimated, particularly as it melds the Party's ideology of market socialism with the *realpolitik* of preventing the emergence of an oligarch class" (Green and He 2005, p. 189). What is important for now is to understand that investment banking, and financial services more broadly, occupies a much more delicate place between political power and daily commerce. Whatever the actual threats of a powerful and influential international financial class in China class may pose for the CCP's monopoly on political organization, they undoubtedly weigh heavily on the policy calculus of a government that has all along has tried to stem the emergence of a viable and independent domestic capitalist class (see, for example, Tsai 2004). As de Jonge (2008) shows, contra to Walter and Howie (2012), the ultimate goal of China's policymakers is to integrate Hong Kong into China's financial markets rather than to outsource China's financial markets to global capital markets. Rather than being a passive agent desperate to fund and revive ailing state-owned giants we can see the CCP articulating a broader strategy that leverages the interests of international

capital with the desire to ‘marketize’ their activities while maintaining control the development of the SOEs.

In this context, the chapter turns to discussing how the Chinese government was able to acquire FFIs’ managerial expertise to transform its state-owned financial enterprises, without ceding control to the former. It does this, however, in the context of the FFI perspective. It looks at how FFIs have sought to enter the Chinese market through partnerships with domestic financial enterprises and, later, in section 4, by introducing an entirely new financial services practice: private equity (PE). This will demonstrate how foreign expertise ended up reinforcing the government’s reluctance to cede the levers of financial capital to foreigners.

### **3.0 Joint Ventures and strategic partnerships**

This section explores two parallel but distinct FFI strategies to make the market more open to FFI participation: Sino-Foreign JV partnerships and ‘strategic’ equity investment by FFIs in Chinese banks. These strategies are part of a broader non-cooperative approach by FFIs to influence how regulators treat them. The goal, in these instances, appears to have been quite myopic: to increase the individual FFI market share. But, as chapter 4 has shown, the goals of FFIs in the case of transforming and listing Chinese SOEs was also non-cooperative, with each investment bank individually vying to profit from China’s increasing integration with the global economy. It looks at how this proceeded in the insurance and investment banking section. Specifically, this implied linking Chinese financial firms closer with their global counterparts by engaging directly with the CCP’s policy goals, with the ultimate aim of loosening restrictions on global capital in China. However, as the case study on the IFC’s partnership with a number of Chinese commercial banks shows, this resulted in the strengthening of the commercial viability of state-owned financial enterprises and provided a way to introduce market incentives into the state-sector while limiting foreign ownership at the same time.

Interviews conducted for the present analysis have consistently failed to reveal anything substantial about the thinking behind these ‘strategic’ investments.<sup>41</sup> While in some cases we can observe traces of a bank strategy—such as with Deutsche Bank purchase of the maximum allotted (19.99%) investment in Huaxia, which apparently allows for some unspecified inter-firm strategic cooperation bank (interview with FFI manager, May 16, 2013)—in most cases there is little good information to make a proper assessment. Moreover, unlike the Deutsche Bank-Huaxia case, which gives the foreign investor a seat on the Chinese bank’s board of directors, in a majority of cases ownership guarantees almost no or very limited role in corporate governance (ibid). As Podpiera and Leigh (2007) show, this applies to the biggest equity investments by FFIs in Chinese state-owned banks. Besides, in some cases, these equity investments are speculative in nature (this is confirmed by virtually all interviews conducted in the Spring and Summer of 2013) or are one small part of another strategy, such as support for an international IPO. At the same time, it is also clear from some interviews (for example, interview with FFI manager, 20 February 2013) that FFIs do, in fact, cooperate with domestic financial institutions as part of an informal agreement that involves a transfer of knowledge or product lines and the hope that such technical cooperation will result in greater market share for an individual FFI. However, as the subsections below will illustrate, these strategic partnership—either through JV arrangement or through equity investments—are often of much more consequential for the development of Chinese financial institutions and (as the case of IFC’s cooperation with the PBoC will show) and for how the central government experiments with financial reforms.

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<sup>41</sup> The word ‘strategic’ is used purely for the sake of designation, as the nature of this ‘strategy’ is not entirely clear.

### *3.1 Insurance companies*

Foreign insurers were among the most innovative in choosing the JV route to enter the Chinese market, partnering with non-insurers—even non-financial institutions—to benefit from the pool of customers available to a variety of SOEs. FFIs began exploring market in the pre-WTO era, when the insurance industry was virtually non-existent and when (unlike in the case of PE), China’s political status quo was marked by a reluctance to welcome industries that may have once been considered ‘capitalist’ in nature. In the late 1990s and early 2000s the domestic insurance market was largely underdeveloped<sup>42</sup> and many foreign firms sought various creative ways to establish themselves in the mainland and ensure a future. As discussed in previous chapters, one of the ways that foreign firms have had ‘influence’ with China’s government is by playing up their ability to utilize foreign expertise to help develop particular industries. This is a particularly neat example of FFIs inserting themselves into China’s elite-based financial internationalization process, with experimentation in modern market liberal insurance practices beginning at the level of elite relationship-building, with much of China’s insurance markets remaining closed. As Maurice Greenberg, then CEO of AIG has noted “you have to spend as much time trying to open markets for the future as you do running markets for today” (Greenberg and Cunningham 2013, chapter 8, para. 13).

The introduction of the insurance business to China proceeded in two steps. In the first step, a partnership between the People’s Insurance Company of China (PICC) and the American International Group was formed, with the latter seeking a way to further market opening in China more than a way to directly profit from the venture. The partnership was meant as a way for AIG

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<sup>42</sup> This underdevelopment can be expressed in terms of a dearth viable market opportunities (few people were wealthy enough or trusting enough to buy insurance), not to mention regulatory hurdles (the China Insurance Regulatory Commission [CIRC] was not fully established until 2003) and political uncertainty related to the market share foreign firms would ultimately be permitted to have relative to domestic firms.

to get an early foothold in China, but it was only one small part of the firm's strategy. Greenberg (as chapter 2 noted) lobbied on China's behalf in Washington, as the US Congress debated giving China permanent most favoured nation status, to overcome the last obstacle to China's WTO accession. But he also served as a business advisor on investment liberalization—as head of Shanghai's International Business Advisory Council—to Zhu Rongji, during part of the latter's tenure as Mayor of Shanghai.

As Greenberg recalls, his early days of partnering with Chinese SOEs involved educating his Chinese partners about the insurance business and convincing Chinese elites (party cadres, SOE managers, and the like) about the benefits of life insurance policies as a financial investment (Greenberg and Cunningham 2011). AIG received direct approval from Zhu Rongji to sell insurance policies on a limited basis in Shanghai in 1992, and operated there without profit for nearly a decade. Zhu had hoped that SOE insurance providers would learn from foreign competition to be more efficient, to accept Western Practices, and to transform and modernize their own businesses. The goal, in other words, was to educate a small number of Chinese elites about the nature of modern insurance and assurance policies and to bring in staff from Hong Kong and Taiwan to carry out extensive training programs (*ibid*).

In the second step, other insurance companies began to enter China to negotiate with potential JV partners and finally forming JV partnerships, as WTO accession formalized JV rules. In 2002 when the PICC signed another agreement with AIG to provide commercial insurance and risk assessment services, the latter followed up with similar agreements with the Bank of Communications and the Guangdong Development Bank (EIU march 2005, p. 60). Many of the pivotal deals in foreign-owned and foreign-invested insurance came in the middle of the last decade when, in 2004, the China Insurance Regulatory Commission (CIRC)—pushed in part by WTO provisions for national treatment in the sector—decided to allow for more foreign penetration of the domestic insurance market. In 2003 Prudential, a British insurer entered into a joint venture partnership with CITIC and another banks to sell policies, joined in October 2003 by French insurer



Groupama and the Agricultural Bank of China to distribute agricultural and non-life insurance policies across ABC's then 2300 branch network (EIU March 2006, pp. 136-137). More innovative strategies quickly were quickly developed by foreign insurers eager to break into a market defined by regulatory restrictions on raising capital and expanding branches. One such strategy involved forming joint ventures with non-financial entities. Manulife partnered with SOE Sinochem to distribute a variety of different policies, again with the aim of accessing markets that were difficult to access.

But as is commonly the case with much of the rest of foreign firms trying to gain access to the Chinese market, insurers found themselves quickly sidelined by their domestic counterparts—and particularly their joint venture partners. While, some initial successes were recorded and regulatory and tax burdens were gradually relaxed in the immediate years following 2004 (see EIU March 2006, pp. 137-138), most foreign firms struggled to make headway.<sup>43</sup> Those firms pursuing joint venture partnerships to attain organic growth saw lackluster results. As a 2009 Economist Intelligence Unit report concluded,

As lock-up periods expire, foreign investors will be reassessing their investments in Chinese companies. Chinese investors and their regulators, too, are also likely to take a closer look at their tarnished Western models. Momentum for Sino-foreign deals in the financial sector is slowing after the enthusiastic matchmaking of the first few years of market opening. Just as Chinese banks are beginning to steer away from dangerous assets in Western countries, foreign investors are cashing out of some of their investments in China. Chinese critics are questioning a reform model that is based on openness to foreign knowledge and technology, and best practices (Economist Intelligence Unit 2009, pp. 110-111).

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<sup>43</sup> Notable exceptions do exist, particularly Manulife-Sinochem, which runs profitable and growing operations to this day.

Thus, helped along by a suspicion of Western financial practices following the 2008 global financial crisis, insurance firms quickly turned instead to passive strategies, such as taking equity stakes in domestic insurers—being as they were, capped at 25% maximum ownership. Setting Up wholly foreign owned subsidiaries also became an option, but to this date, this remains an enormous challenge, as opening new branches remains a bureaucratic challenge and competing in a market well saturated by state and private domestic players has proved very daunting in practice .

Thus, despite Greenberg’s nearly three decades of lobbying and currying the favour of Chinese leaders, the insurance industry in China remains largely in domestic hands. Certainly, FFIs held up their end of the bargain: modern insurance practices have slowly but steadily spread throughout the Chinese market. But ultimately, the elite-based approach of internationalizing Chinese markets was self-defeating for foreign insurers. Rather than opening up a segment of the insurance industry to foreign competition, the approach, premised on “opening the Chinese mind” (Greenberg and Cunningham 2013, chapter 8, para. 30), simply linked up SOE managers with foreign talent and practices and allowed them to develop their own modernization strategies. The approach was inherently non-cooperative, and unlike in the case of lobbying US legislators for China’s WTO accession, the JV and partnership arrangements were only based on the hope or assumption of future market opening, not any formal stipulation thereof.

### *3.2 Investment banking.*

Foreign investment banks—most notably European and American banks—have been very eager to jump on board early as Chinese authorities began to formalize the rules for foreign involvement and to allow predictable institutional channels for entering domestic retail banking and equities markets. In 1995 Morgan Stanley secured a deal to establish a joint-venture securities

company—China’s first investment bank with a foreign co-owner—called the China International Capital Corporation (CICC) with China Construction bank. The arrangements were ripe for Morgan to exert political influence—the only sure path to success in the decade when the still-predominant political hostility to foreign financial interests made such influence essential—to gain a foothold in China’s nascent financial markets. The CICC boasted Levin Zhu, the son of the former Premier, as senior manager, and was chaired by the CCB president. If the team at Morgan wanted to participate in key domestic deals, such as IPO listings, M&A transactions, and securities trading, this seemed to be a substantial breakthrough.

However, similar to the experience of foreign insurers, linking up Chinese elites and SOEs with foreign talent and practices, rather than linking up domestic markets directly with global markets (such as, for instance, the case with garments and electronic assembly for exports) simply had the effect of helping Chinese enterprises acquire foreign expertise and precluded the actual need for foreign participation. In the case of linking up directly with global markets, the whole industry is exposed to global competition and transaction costs (as per Keohane and Milner 1996) are transformed entirely. In the case of elite-based linkages, the effect is to maintain transaction costs as is for the industry as a whole (capital controls play some role in this, but so does licensing and other regulatory restrictions), while exposing Chinese party elites and SOE managers to the logic of the global market. As such, organizational changes can be made in domestic financial institutions to make the industry mimic global standards and practices, and only to the extent that policymakers would like. As Stephen Green has noted:

On the one hand, the American firm has taken part in creating what is now widely regarded as China's best investment bank. Experience has been gained and some good relations fostered. On the other hand, CICC has failed to live up to Morgan's initial hopes of being an entry-vehicle into the Mainland market. Instead, the Americans have lost any effective control over management of the venture and,

even worse, appear to have created a successful rival. Ironically, with WTO entry, such are the rules governing joint ventures that Morgan was actually forced to reduce its stake in the bank in February 2002 from 35% to 34.2%, allowing the domestic owners majority control. CICC therefore acts as a salutary reminder of the dangers of establishing a joint venture in this sector (Green 2003, p. 202).

Morgan sold its stake in CICC to two US private equity firms, KKR and TPG Capital, as well as to Singapore's Great Eastern Life and Government of Singapore Investment. Similar results can be observed among foreign banks' partnerships with Chinese financial and non-financial institutions alike. For example, "Changjiang BNP Paribas (JV between Changjiang Securities and BNP group) sold its stake in January 2007. Lack of management control combined with capped equity stakes meant that most foreign investors could only take dividends but not participate actively in the China business" (EIU March 2011, p. 62). Eventually, BNP came to the same conclusion and also withdrew its stake in the firm, which was called "a setback for BNP's China strategy" (Tucker and Dyer 2007). Although foreign banks consistently rank the ability to exercise ownership as the single most important variable in establishing a joint-venture operation, this feature of JV operations by foreign banks seems to have generally under-delivered. PwC surveys (2004-2008) consistently show that foreign banks used to rank the ability to leverage their JV participation to attain other market-entry goals as important variables for making the decision to initiate a JV. But the effects of this have rarely been more than the aforementioned transfer of foreign expertise from the FFI to its Chinese partner, with perhaps some material gain for the former following the appreciation in the value of its equity or partnership stake.

Following China's WTO membership in 2001, the potential for foreign firms to remake the Chinese market was received with enthusiasm and foreign-domestic cooperation looked more likely to be one of foreign banks partnering with smaller, more market-driven, medium-size banks—eventually leading to foreign-led privatization of banking services (Kyne 2002). However,

as state-owned banks restructured and rushed to raise capital abroad, reasserting their place as dominant players in much of China's domestic financial markets and retail banking space, partnerships (JVs, including 'strategic' equity holdings) between foreign banks and domestic medium sized financial institutions had typically under-delivered. For instance, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, RBS, Credit Suisse, Deutsche Banks and UBS have used JV arrangements to break into what has been, until quite recently a booming domestic IPO market, as SOEs as well as SMEs scrambled to list in Shanghai and Shenzhen.<sup>44</sup> However, by 2010 JV securities firms accounted for only 2.4 percent of the profits in the domestic IPO-underwriting market (Li 2011). Coupled with the partnership-breaking disputes relating to managerial control (such as those described above), domestic firm dominance in this market has become increasingly pronounced as domestic players continue to leverage their increasing access to managerial and technical expertise from returning expatriates and former foreign bank employees to keep foreigners out.

While survey data is not available to make historical assessments of the two decades in question (the 1990s and 2000s), we can nevertheless draw a loose but useful comparison based on available information. In the 1990s, JVs of all sorts were an important stepping-stone for foreign companies to enter China. They were used to gain a foothold in a country whose policymakers were after foreign technical and managerial expertise, but that were nonetheless weary of foreign ownership. Many joint ventures were the products of ad-hoc deals struck between local authorities and interested foreign firms, made with the implicit blessing of reformist policymakers at the centre, who wanted to encourage local-based experimentation as a way to circumvent central opposition to privatization and foreign participation (e.g. see Zweig 2002). But since China's WTO membership and the consolidation of power by central regulatory agencies, joint venture

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<sup>44</sup> In the last two years, the CSRC put a hold on IPO approval as it undertakes an overhaul of its approach to overseeing a national stock market that has become infamous for fraud and being driven in large part by speculative activity.

partnerships became a rather insignificant driver of change. By the middle of the last decade, foreign banks have consistently ranked their joint ventures as a relatively unimportant driver of change in China's financial sector. For instance, according to surveys conducted almost every year since 2005 by Price Waterhouse Coopers (PWC) the role of JVs in this regard has ranked consistently and increasingly lower than other potential market drivers like regulatory changes (which consistently ranks first), funding constraints, and even vague factors like globalization and technology. In fact, by 2011 joint ventures were nearing zero in the PWC-constructed index of relevance (see PWC 2011, p. 19).

To be sure, several large foreign banks have continued to make use of the joint-venture partner arrangement in order to break into domestic investment banking markets in China. For example, in 2008 Morgan Stanley began a JV partnership with Hangzhou Industrial and Commercial Trust and in 2011 it formalized a JV with Huaxin Securities, focusing on underwriting and sponsoring domestic equity and bonds (as well as proprietary trading). Similar deals were struck that same year with Foreign-Chinese securities company JVs involving RBS (Reuters 2011), Citigroup (Citigroup 2011) and JP Morgan (Gopalan 2010). And indeed, in May 2012 China raised the ceiling of the maximum allotted ownership limit in joint ventures from 33 percent to 49 percent. The same set of regulatory changes further allowed foreign firms to establish JV brokerages for the purpose of trading Chinese futures, which includes both financial derivatives and commodities (Rabinovitch and Hook 2012). These changes came after years of both direct and indirect lobbying by foreign banks, often formally through European and American chambers of commerce, and through government-to-government channels, such as through the US treasury .

But fundamentally, the assumption that JVs would lead to a stronger foothold in China's investment banking and securities markets has not borne fruit. Much like the case with insurance explored above, and as will be shown in the subsection, below, on commercial banking transformation, the transfer of expertise to Chinese firms and the overall strengthening of the Chinese financial sector through foreign-aided partnerships has allowed Chinese firms to thrive

largely on their own. And besides, foreign capital's comparative advantage in Chinese equity markets, making long-term, market-based risk assessments in a liberalized financial environment, offers them little advantage in the more politicized environment that still defined the Mainland equity markets (Walter and Howie 2012). Indeed, if FFI's real comparative advantage in the investment banking is the market-efficient allocation of capital allocation, then perhaps their time in reforming domestic equities markets may yet come (Interview with FFI manager 16 May 2013). But for the time being, their role has been limited to restructuring the financial sector, not becoming an important part of it. The next subsection seeks to illustrate this point further, with a case study on commercial banking restructuring.

### *3.3 Case Study: IFC's push to Transform Financial Management Through Strategic Partnerships.*

Why have FFIs not have had the same success in pushing China to make its domestic commercial banking markets more open to their presence by lifting ownership restrictions or by bureaucratic reducing obstacles to their business scope (e.g. branch expansion)? A number of the reasons will be explored in the last section of this chapter. But this subsection explores an additional, potentially important reason: private FFIs were not forthcoming—if not outright skeptical and non-responsive (Paulson 2015)—to China's outreach inviting them to be strategic investors that would put up their own money (rather than capital markets funding) in domestic bank restructuring. As this section will demonstrate, FFIs role—much as in the case listing Chinese SOEs on global stock exchanges—can also be defined as one of piggybacking on the early, small-scale, piloting efforts of other institutions. In this case, this institution was the World Bank's smaller scale, commercial banking-like arm, the International Finance Corporation (IFC), which specializes in working in and with the private sector in developing countries.

While evidence is lacking as to whether or not this had had a profound impact on policymakers' relationship with FFIs, it is nonetheless worth noting that by the time HSBC, Goldman Sachs, Morgan Stanley, and UBS began their push to invest in China's biggest state-owned banks and help them re-structure their management and commercial banking practices (this will be explored in more detail in section 4), China's state owned banks already had experience with importing Anglo-American financial management and expertise. In fact, it was not a private (per se) FFI that first reached out to help them change the way they approached and understood commercial banking: rather, it was the World Bank's private sector arm, the International Finance Corporation, that took the initial steps in this direction.

Contrary to Walter and Howie (2012) and Paulson (2015), American FFIs were not the first to introduce Anglo-American banking practices to China. In fact, the Asian Development Bank (ADB) took the first significant step in this direction, investing in China Everbright Bank in 1996. This predated China's WTO accession and went ahead despite a 1994 promulgation passed by the PBoC stating that no foreign entity was allowed to invest in a Chinese bank. As the IFC has itself noted this investment, along with all subsequent purchases that were made by the IFC, up until 2003 when the CBRC instituted formal rules for foreign investment in the Chinese financial sector, "were all approved on a case-by-case basis as exceptions by Premier Zhu Rongji" (International Finance Corporation 2012, p. 16). The previous year that the ADB made the foray into helping Chinese banks import financial practices from abroad, the IFC entered China with the goal of, ultimately, privatizing the banking system "through making equity investments and providing technical assistance" (International Finance Corporation 2012, p. 17).

In 1995, the IFC began to work with the PBoC on the consolidation of urban cooperatives and trust companies into city commercial banks (these were local-government owned). Specifically, it advised one of 5 banks that emerged from the pilot consolidation program: the city government-owned Bank of Shanghai. Working in collaboration with the PBoC the IFC provided technical assistance to the Bank of Shanghai, eventually purchasing 5 percent of the bank's equity



shares with the PBoC's permission. The ultimate goal, as the IFC noted, was to show the global financial community that it was possible to restructure Chinese banks along global standards (IFC 2012). In 2001 the IFC raised its stake in the city bank to 7 percent and successfully invited HSBC to be its partner in reorganizing transforming the bank along Anglo-American lending and management standards. HSBC (along with a small Hong Kong-based Bank of Shanghai) became the first major private FFI to make an equity investment in the bank (ibid). The same year IFC purchased shares in the Bank of Nanjing, which was created and piloted along the same lines. The year the IFC made this investment, the PBoC showed them a draft of a new regulation—to be formally promulgated by the newly created CBRC in 2003—that would stipulate the terms for foreign investment in China's banks (ibid). It could be said that the IFC's work with the PBoC and the Bank of Shanghai not only sent important signals to other FFIs, but that it also helped Chinese authorities decide where to draw the line on FFI investment in Chinese banks. Everything from risk management, stress-testing bank balance sheets, and corporate governance were reformed in such a way as to make the bank visible and understandable to potential investors (ibid).

Over the years, it had also made additional investments in Xian City Commercial Bank, the Bank of Beijing, Minsheng Bank, Industrial Bank, and URCB. Their cooperation with the institutions had varying degrees of success (International Finance Corporation 2012), and helped Chinese policymakers learn foreign practices could, and which could not, be transferred to the mainland banking system. The IFC helped to bring in a number of weary FFI investors on board to provide capital for reforming China's banking system, including PNB Paribas and Scotiabank (Hamid and Tenev 2008). As Paulson (2015) notes, Chinese authorities made it quite clear that they were in need of capital—money, not just expertise—to restructure Chinese banks. However, at the beginning of the restructuring process, in the late 1990s and early 2000s, few FFIs were willing to pay what authorities deemed to be a sufficient amount, let alone make an investment without taking a controlling stake in a bank. The IFC, in a way, helped the PBoC to convince FFIs that there was strong growth potential in the Chinese banking system and that, more importantly, minority stakes

were worthwhile. As Hamid and Tenev (2008, p. 461) note, “...few foreign investors other than IFC were willing to take such small minority stakes in the Chinese banks. Therefore, IFC was able to fill a gap thereby playing a catalytic role in attracting foreign strategic investors in part because it is not perceived as a potential competitor and in part because it is willing to be an active investor with a small equity stake.”

By 2004, when HSBC decided to buy nearly 20 percent of the Bank of Communications (explored in section 4), Chinese policymakers already had several working models for reforming their state-owned banks. It is, therefore, not reasonable to suggest that FFIs had played a much smaller role in the development of Mainland banking and capital markets, than the much more significant role they played in the development of China’s offshore (Hong Kong) and overseas (New York and Elsewhere) equity markets, in part because FFIs were simply not needed to the same extent. Indeed, FFIs commonly complain that the consumer credit market is nearly closed to foreign participation, with Union Pay a state-owned consumer credit and debit monopoly, effectively in charge of payments systems across the country. In the context of the IFC’s involvement in transferring financial expertise to Mainland China this is far from surprising. In fact, the IFC worked with the PBoC in 2003 to establish a consumer credit information system and to draft legislation governing China’s payments systems. Indeed, by the time private FFIs expressed interest in this sector, their expertise was not necessary to develop a functioning and well-supervised market.

#### **4.0 Private equity: foreign practices in a local context.**

Perhaps the least researched aspect of foreign financial actors in China is the private equity (PE) sector. While private equity firms, largely US-based ones, have been in China since the 1980s—facilitating the movement of the majority of silicon-valley based outbound capital to end

up in China some twenty years later (Robertson 2010)—the industry has only started to take off only very recently. Beginning in 2002, an industry that remained politically tenuous in many countries until recently<sup>45</sup> had within the span of a decade mushroomed, declined, and again planted seeds of another renaissance (circa 2012). While one interviewee had expressed hopelessness about the future and economic impact of the PE industry in China in general (interview with chamber of commerce representative, 6 March 2013), foreign PE actors themselves have been more optimistic about the potential of the industry, especially regarding their role in the secondary PE market, where acquired firms are bought and sold among through competing bids by different players in the market (e.g. interview with FFI manager, 27 June 2013; China First Capital 2013).

Robertson (2010) has noted that, despite foreign resistance to the influx of PE actors and norms in Europe and Asia, there has been a gradual acquiescence of said norms and practices over the past three decades. Much of these have been American origin and despite concerted efforts at fostering the emergence of a made-in-China PE model (and even attempts to create alternative PE norms and practices), cross-border homogeneity tends to trump local heterogeneity. With respect to private equity in Asia, Robertson has made two observations:

First, the spread of private equity has been founded on interdependent relationships between US actors and local actors, which have more successfully grounded the private equity industry in national political economies than its origins in the Asian crisis period. Second, despite the relative localization of Asian private equity, industry practices are still largely shaped by the US model of private equity and the merger and acquisition activity that it entails, rather than a distinct Asian private equity model (Robertson 2012, p. 637).

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<sup>45</sup> Indeed, even European, Japanese, and Korean policymakers had lagged behind the US in accepting PE practices; see Robertson 2010

However, while this view is certainly confirmed in many broad respects—as Robertson (2012) notes, joint venture activities, coupled with the phenomenon of Chinese national ‘returnees’<sup>46</sup> bringing Wall Street-acquired knowledge to domestic PE firms—certain caveats, as observed by recent experience of PE activities in China, ought to be noted.

First, private equity in China has indeed seen a separation between domestic and the foreign players. However, this separation is not so much a normative one, but rather one related to the incentives facing the firms involved in M&A activities in the mainland. It has been known for some time that state-owned and private domestic SOEs have pursued a single-minded strategy of taking over already private firms without any desire to affect managerial or operational changes. The aim is to set the struggling firms up to list in Shanghai or Shenzhen. The revenue therefore accrues from investors rather than from ‘extracting value’ as per the American model. This is very different from the strategies employed by Wall Street firms, which typically take public firms private in order to reorganize the management and operations, relisting them or selling them to another PE firm once internal managerial and operative changes have been made (interview with FFI manager, 27 June 2013). The IPO-based strategy that has been predominant among domestic firms exists for a number of reasons. Many private firms in China lack the willingness or prerogatives to relinquish control. One foreign PE sector participant remarked that many Chinese small- and medium-sized enterprises (SMEs) are often family-run businesses with owners with little understanding of how to legitimately turn a profit. In turn, the more attractive takeover targets are scooped by state firms like CITIC Private Equity, which offer more lenient restructuring conditions and have greater access to capital (*ibid*). In this instance, we ought to be reminded of the systemic obstacles to FFI market expansion, as outlined in chapter 3: capital controls simply make it difficult for FFIs to compete with their domestic counterparts on an equal footing.

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<sup>46</sup> Robertson (2012, p. 649) defines returnees as “individuals who have returned to domestic finance after spending significant time in a global financial city or working for a major foreign financial institution in an Asian capital.”

However, recent events have changed this phenomenon in favour of foreign firms in two ways. First, due to the CSRC's desire to combat fraud and reduce speculative activity in domestic stock markets the agency froze IPO approvals for almost two years, starting in 2012. This has had the effect of making the hands off PE model practiced by domestic PE firms largely unworkable. Moreover, as auditing practices and balance sheet disclosures improve—not to mention the increased willingness of Chinese SMEs to accept the loss of managerial control and to share financial information (interview with FFI manager, 27 June 2013)—private SMEs increasingly seek out foreign firms' expertise in managerial restructuring. Second, State firms are showing more willingness to do business with foreign PE firms. Some recent trends, to be discussed in more detail in the next section, suggest that the increasing concern for efficiency among government agencies and SASAC's willingness to privatize some assets of existing state firms (part of the State Council's "grasp the large, let go of the small" approach to privatization) gives foreign firms cause for optimism (China First Capital 2013).

As one foreign PE actor in China explains, SASAC's concern for revenue and asset growth and investment usually puts considerably less pressure on an SOE to increase profits than might otherwise be the case. This, in turn, makes the foreign PE actor's job of making a firm more profitable considerably straightforward (China First Capital 2013b). As he describes:

You don't need to be a Buffett, Bonderman, Kravis, or Rubenstein to make money buying the right Chinese SOE. You generally don't need to get your hands too dirty, launch a hostile takeover, borrow a ton of money, or make yourself unpopular by firing surplus workers. It's going to be enough in most cases just to retain and incentivize current managers, and inform them that their goal now is to deliver net margins as good as, if not better, than private sector competitors (ibid)

The more interesting part of this new trend is that SASAC and state firms themselves are

increasingly more open to take foreign advice on privatization. This might be because the first round of privatizations in the 1990s had ended up benefiting rent-seeking insiders and produced little improvements in efficiency (China First Capital 2013b). Moreover, with many PE investments stranded waiting for IPOs that will either never materialize, or materialize too late, Western firms (who have been more reluctant to jump on the straight-to-IPO bandwagon) see many opportunities to buy private SMEs and SOEs on the secondary market and turn a profit. Moreover, as the SEC cracks down on Chinese firms listed in the US, PE giants like Carlyle and KKR are actively taking some of these firms private (Gough 2013). As Mainland China IPOs are currently making a comeback foreign PE firms appear to be better positioned than foreign banks and insurance firms to profit from changes in China's financial system and its economy. In this respect, it may be that foreign PE actors are the exception to the rule illustrated throughout this chapter: rather than taking a backseat to domestic firms and taking a small share of the market, they appear to be uniquely positioned to take a successful slice of China's emerging M&A and secondary PE markets.

But, just as in the cases explored above, FFIs are held back precisely by the same strategy that helped them to enter and expand in China's market: fermenting elite-based, expertise-centered linkages to gain market access. Part of the reason for the uncertain environment that is likely to continue to define the foreign PE landscape in China is because much of the managerial talent that they once brought to China has allowed a domestic PE industry to flourish and, more importantly, to mostly displace foreign players in the market (Robertson 2015). Moreover, Chinese policymakers have enacted a 'returnee' incentive policy that has increasingly allowed China's financial system to benefit from managerial and technical expertise for which they once relied on FFIs. The next subsection explores these two obstacles for FFIs involved in PE in the Mainland.

#### *4.1 PE and Elite Internationalization: The Ironic Consequences of Hank Paulson's China*

##### *Strategy*

In *Dealing with China*, Paulson made it quite clear that part of Goldman's approach to doing business in China was, in the early days, "educational" (Paulson 2015, p. 39). Similarly, Walter and Howie (2012) point out that in the 1990s there was an emphasis in China's financial sector on learning from the American model of finance because "Citibank, Morgan Stanley, Goldman Sachs, and Bank of America were seen as the epitome of financial practice and Wisdom" (Walter and Howie 2012, chapter 3. Para. 55). However, by the mid-2000s, the need to 'learn' from Anglo-American financial practices had markedly declined. As the present analysis posits, one way that FFIs were able to influence the process is by building elite/returnee linkages between the mainland financial community and global financial elites. As chapter 4 describes, Goldman Sachs succeeded to re-organizing and raising capital for China mobile in part because of the trust earned from Chinese authorities not only of Goldman as a firm but, more importantly, of Anglo-American finance. Paulson recalls that it was important to hire staff that not was not only educated in top US schools in business and finance, but that also had experience working in the Chinese government.

Robertson (2015) calls these kinds of linkages returnee-princeling connections. They form an alliance between internationally oriented elites (the returnees) and the domestically oriented ones (the princelings). The former looked to connect international capital and practices with the domestic market. Initially, this linkage was created because returnees were hired and brought to the Mainland, in the case of finance, by FFIs looking to access China's commercial banking, insurance, investment banking, and PE (and its close cousin M&A) markets.

During the 1990s, the concept of PE was a new one in China. Moreover, at the time, many princelings were weary of cooperating directly with foreign managers due to the professional and cultural/linguistic barriers that made it difficult to explain and justify foreign practices in the Chinese context. Foreign PE firms entered the Mainland market in this context largely because it

constituted a regulatory grey zone, marked by an absence of explicit laws forbidding or even regulating the sector exclusively. Whereas in the pre-WTO accession, a lack of explicit disallowance of the practice did not mean that FFIs could actually enter the market—the private sector was quite small and only gained legal and political legitimacy in 1993, when the 14<sup>th</sup> Party Congress called for the development of a “Socialist Market Economy”—WTO accession gave clear protections to foreign firms to introduce the practice. And for a number of years, due to a lack of domestic competitors, public or private, FFIs basically lifted PE out of its Wall Street context and transplanted it onto the Chinese landscape. To do this they brought with them Chinese nationals that graduated from US and UK business schools and established a reputation in some of the top Wall Street PE firms. These individuals could speak Chinese, understood the logic and pitfalls of the Chinese private sector and quickly built a reputation for themselves in Shanghai and Shenzhen. Unfortunately for foreign firms, however, there was nothing keeping them loyal to their Wall Street mother firms. Indeed, such loyalty was at best only very marginally encouraged in the culture of Anglo-American capitalism, and the returnees soon realized that they could thrive and excel on their own. All they needed was capital.

This is where the opportunity of approaching princelings, which headed state-owned giants like CICC and CITIC Capital came to be. In the late 1990s and early 2000s the CCP’s vision of strengthening the state sector by privatizing smaller, less efficient state companies, and consolidating the more efficient once into large conglomerates, begun to take shape (the concept of “grasp the large, let go of the small” was envisioned in the 1996 15<sup>th</sup> Party Congress but was rolled out very gradually thereafter). For example, between 1998 and 2005 the state’s share in industrial output shrank from 50 percent to 30 percent (Hsieh and Song 2015). But because China’s SOE managers and bureaucrats were reluctant to sell to foreigners, returnee PE entrepreneurs saw an opportunity: convince state-owned investment banks to enter the PE space and, otherwise, explain to princelings the great financial opportunities of PE capitalism and use the latter’s connections to start their own firms and bid on state assets that were being privatized. It appears that Henry



Paulson's strategy of fostering linkages between the CCP and returnees worked quite well. The only problem for FFIs was that there was nothing keeping returnees within the foreign financial community.

Robertson (2015) notes that, with respect to PE, China underwent a process of 'replica localization,' whereby foreign—specifically, Anglo-American—PE practices were imported but were significantly modified to suit the local context. This localization has a number of characteristics. The most important one is their greater reliance of government relations and relationship-based deal making. Wall Street-born PE practices are based on the ability of PE firms to seek out companies and sectors with growth potential, take them over at a 'discount,' restructuring them (this often involves shedding staff and managerial reorganization), and subsequently selling them to private buyers or in a public offering. In China, this approach runs into a number of local obstacles.

With respect to PE, the two most pertinent obstacles are the continuing influence of relationship—as opposed to transactional—banking and the political sensitivity of privatization and large-scale layoffs (interview with FFI manager, 27 June 2013). With respect to the first, while the returns from acquiring 'good guanxi,' especially in the anti-corruption era environment, may be on the wane, relationship based financial deals are not necessarily on the way out. In fact, in many countries, transaction-oriented, formalized, contract-based financial services have not fully replaced relationship banking. In fact, even many mature financial economies continue to exhibit characteristics of relationship-based deal making, wherein loans and financial acquisitions are based on mutual trust between financial institutions and their clients, rather than strictly relying on contracts and balance sheet oversight, as in the Anglo-American model (Selmier II 2015). Indeed, Selmier II (ibid) has suggested that banking practices can best be understood on a scale between relationship-based and transaction-based business. China certainly still exhibits many characteristics of the former (Ibid); private equity, too exhibits many of these characteristics (interview with FFI manager, 27 June 2013).

With respect to the second obstacle—that is, authorities’ sensitivity to privatization—FFIs have, again contributed to creating their own obstacles. Given the significant role that foreign investment banks played in helping SOEs restructure and raise capital abroad (i.e. the process of spatial internationalization) the need for foreign capital and participation in the Mainland market had to a great extent subsided. Flush with foreign capital raised in Hong Kong and New York, and controlling large and significantly more profitable state enterprises, SASAC could be more selective about the valuation of the state assets they were looking to sell (the “small” they were looking to let go off). Quite simply, there was no urgency of a Soviet-style privatization fire sale. Domestic PE firms, armed with well-connected princeling managers and skilled, knowledgeable returnee staff could arrange to take small and inefficient state firms private, enact slower and longer term-restructuring plans, and lay off less people and over a longer period of time. The world of hostile takeovers, mass lay-offs, and ruthless competition did not exist in Shenzhen and Shanghai, in the same way that it does in New York. Moreover, because state-owned institutions like CITIC and CICC are flush with capital, the Anglo-American PE model has been, effectively, turned on its head. Rather than competing for PE capital, private Chinese firms and privatized SOEs instead court multiple PE firms, which attract take-over targets by offering more lenient take-over and restructuring terms (China First Capital 2013; interview with FFI manager, 27 June 2013).

To summarize, Chinese PE firms, especially the state-owned or state-connected firms like CITIC Private Equity Funds Management, are able to flourish in this environment because, as Robertson (2015) explains, they could take Wall Street practices and localize them—tailor them to suit this more idiosyncratic local political environment through their connections with foreigner-weary state officials. To illustrate, we see that minority-stake PE deals (what the industry calls ‘growth capital’) are particularly high in China, with turn-around/restructuring deals extremely rare (KPMG 2008). Moreover, PE deals in China tend to more closely approximate those in the venture capital world elsewhere, providing capital to help firms take advantage of China’s fast-growing consumer economy in exchange for minority stake in a firm (European Chamber and Bain 2012),

with little or no managerial control (China First Capital 2013).

As Robertson (2015) explains, this is a product of much more than market differentiation. Rather, it is a natural outgrowth of China's political economy, which sees domestic capital enjoy a number of advantages vis-à-vis their foreign partners, including easier access to PE deals and capital. For example, Robertson argues that CITIC Private Equity is notably successful because it is essentially a "princeling firm," due to its large princeling contingent among the staff. And while competitors Morgan Stanley are no strangers to hiring princelings to harness 'good guanxi,' they have far less access to deals involving state-owned companies than CITIC and its peers, much in the same way that foreign commercial banks have much less access to lending to SOEs than their state-owned counterparts. Moreover, domestic firms are relatively better positioned than their foreign counterparts in raising funds for PE deals in part—at least for companies like CITIC—through their better access to the state-owned banking system, not to mention "key investors" like "international and national pension funds, sovereign wealth funds, insurance companies and private Chinese companies," (Robertson 2015, part 4, para. 37) which are attracted to princeling-populated PE firms (ibid). Raising RMB funds is especially important in the context of China's capital controls—another systemic obstacle that Anglo-American firms, used to operating in a free-moving capital environment, find rather alien.

While certain foreign PE firms have gone out of their way to fully localize their China operations by giving a great degree of autonomy to their Chinese subsidiaries—notable examples are Carlyle, KKR, Morgan Stanley's PE arm, and Warburg Pincus (Robertson 2015)—they ultimately lost ground to their domestic counterparts, who were better able to execute these modified foreign-modified PE strategies in the mainland. As a result, local PE firms moved from a marginal position of concluding some 9 percent of PE deals in 2003, to well over 60 percent of them in 2013 (Robertson 2015). As one PE practitioner notes, "implementing models based on their success in Western markets is [...] fruitless. [Their] strategies have taken 30 years to mature in

North America so can't necessarily be transplanted to China. All [PE firms] can do is tailor an approach to conditions on the ground and execute consistently” (Doug Coulter quoted in Liu 2013).

This trend toward localization has been further buttressed by China’s policies of incentivizing Chinese expats to return to work in local Mainland companies. As early as 1990 and onward China’s Ministry of Education (MoE) set up a number of funds to give financial incentives to Chinese students to return home to work for SOEs (later these were extended to private enterprises). In 2003 President Hu Jintao announced that bringing foreign-educated mainlanders home was a key priority of the Central Government. As a result, the MoE set up offices abroad and at home to coordinate a campaign aimed to bringing Chinese expats home (Zweig 2006). As standards of living in cities in the Mainland improved, and as foreign companies relied on returnee staff in greater and greater numbers it became increasingly attractive for Chinese expats to return home (Wang et al 2011). In the PE industry, the greater acceptance of Anglo-American finance (the very legitimization of private equity, which was politically taboo just two short decades ago), coupled with continuing systemic obstacles to incorporation and FFI branch expansion in the Mainland (as outlined in chapter 3) has allowed domestic PE market entrants to hire returnees in greater numbers. Because these individuals have often already worked in PE firms on Wall Street, or at least at foreign PE firms in China or Hong Kong, the combination of the systemic advantages outlined above with the increasing attractiveness of returning home to take up top position in domestic PE firms has led to a situation where “Foreign capital is no longer the principal deal-maker in Chinese private equity but... remains a key financial sponsor” (Robertson 2015, p. 35).

Looking beyond the concept of localization, the experience of the foreign PE sector in China’s financial system conforms to the theoretical framework suggested in this thesis: that of internationalization, and specifically, to the sub-framework of internationalization through elite-based linkages. FFIs’ comparative advantage since the industry began to rapidly expand in 2005 was their expertise. In a sense, foreigners created the Chinese PE industry from scratch. They brought their expertise—their Wall Street expertise—to the Mainland largely by bringing returnees

and creating knowledge-based, or epistemological (Adler and Haas 1992; Schmidt 2008) linkages with the global PE community. This allowed China to benefit from ‘state-of-the-art’ PE practices without building them from the ground up, much like in the case of attracting foreign capital and experience for SOE and financial institution restructuring in the 1990s and early 2000s. Foreign PE firms allowed them, again, to benefit from the global financial system. But, much as in case of investment and commercial banking, this did not mean opening the borders fully or completely copying foreign practice. The elite-based linkages established by the returnees they had brought back from Wall Street did not mean that foreign firms would find it easier to do business in local currency—capital controls still apply. Likewise, it did not mean being more accepting of privatization—a key component of PE practice on Wall Street. As Robertson (2015) has shown, replica localization again allowed China to have its cake and eat it to: to benefit from foreign practice but also to embed it in local conditions. And, not surprisingly, these conditions benefited domestic firms, which fare much better in the state-influenced and capital flow-restricted environment that defines China’s financial system.

### **5.0 The limits of knowledge transfer.**

To what extent have FFIs’ transfer of Anglo-American expertise through elite-based channels—via strategic partnership and JVs—been internalized by Chinese insurers, investment and commercial banks, and PE firms? To a large extent, a complete and empirically satisfactory answer is beyond the scope of this study, as it requires an in-depth examination of Chinese financial institutions, not FFIs. Moreover, because financial reform is an ongoing process in China—and especially because the Xi/Li government has recently unveiled an ambitious financial reform agenda (see Tanaka 2015 for a brief overview)—the extent of expertise transfer ought to be a subject for future research. However, in order to more firmly situate FFIs’ role in Chinese financial

sector policymaking in the area of importing foreign expertise, it is worthwhile to make a brief assessment of the developments on this front.

With respect to PE, Robertson has already done the brunt of the empirical work, concluding that “foreign practitioners are being replaced by domestic elites while the Anglo-American model of private equity remains largely untouched” (2015, p. 5). However, with respect to the insurance sector and investment banking sector, the answer is anything but clear. Quite simply, there is very little original IPE or China studies research on the insurance industry in China. With respect to commercial banking, on the other hand, recent studies do provide important insights. Huang (2012) has provided some evidence suggesting that the idiosyncrasies of China’s political economy, such as the prevalence of relationship-based banking and the importance of bureaucratic loyalty in securing career-based goals (e.g. promotion), continue to limit the number of state bank executives and managers with internationally-recognized credentials (this makes this industry quite distinct from PE, where being trained in top Anglo-American universities is almost a prerequisite to career advancement—see Robertson 2015). At the same time, as Huang illustrates, important bank executives such as the CCB’s Xiao Gang have made it a personal goal to change the culture of the banks to one where financial management expertise (i.e. Anglo-American financial management expertise) plays a more important role in management promotion.

Similarly, Levy and Meyer (2012) show that despite having a significant number of non-CCP-selected outside Board members in the Big Four Chinese state-owned commercial banks, “independent outsiders supply few network ties to the global financial community” (p. 487). At the same time, Levy and Meyer note that Chinese state-owned banks have, in fact, tried to increase the presence and influence of international financiers with links to the broader global financial community (albeit not exclusively ‘Anglo-American’). In 2010, for example, ICBC hired a Deutsche Bank Executive to serve as its Vice President (Levy and Meyer 2012, pp. 490-491). This broadly reflects Huang’s (2012) conclusion that despite institutional limitations to the influence of the Anglo-American financial community there—the extent of which is not very precisely

understood—there is a broad, top-down effort to (paraphrasing Wang 2007) have China’s commercial banking industry ‘link up with the *international* financial track.’

## 6.0. Conclusion

This chapter has examined the role of FFIs in China’s financial evolution through the lens of FFI business strategies undertaken by individual foreign financial institutions, as well as by whole sub-industries, such as private equity. It has shown that FFIs’ efforts to open up the Mainland market by fermenting linkages with Chinese elites was only successful for a short period of time; that the result of fostering returnee-princeling linkages has been, much like in the case of insurance, commercial, and investment banking, to transfer expertise to CCP-linked elites. In the end, the incentive structures of China’s financial system and the preponderant role of the state therein remained the same—it was only a matter of time before SOEs and private indigenous firms would take over the PE space. This stands in stark contrast with the role that FFIs played in internationalizing China’s financial markets, which was explored in the previous chapter. Simply put, the reason that that spatial internationalization worked so much more firmly in their favour is because FFIs already define the institutional and normative landscape of the global financial system. I distinguished between whole-market internationalization, which alters transaction costs for an entire sector, and elite-based internationalization. The latter involves exposing Chinese party elites and SOE managers to the logic of the global market, so that organizational changes can be made at home to make the industry mimic global standards and practices only to the extent that policymakers would like.

The case of PE should also remind of HSBC’s and Citibank’s push (discussed in chapter 3) to have China’s laws on foreign ownership in its state-owned financial institutions altered to favour foreign investors. In both of the cases, heavy lobbying, favourable circumstances, and long term commitments have not paid off. It has been suggested that the central government’s firm

stance on foreign ownership is at least in part due to FFI's successful role in restructuring China's state-owned financial enterprises. The case of the IFC's participation in restructuring Chinese commercial banks illustrates this quite well. Indeed, foreign-ownership laws were set in the context of the PBoC's nearly decade-long pilot project of using FFI expertise (in close cooperation with the IFC), which relied on minority equity purchases by FFIs in Chinese state-owned banks, to restructure and 'marketize' the operations of state-owned banks. By successfully strengthening Chinese state-owned banks FFIs quite ironically precluded any immediate 'need' (from the perspective of the CCP) to introduce foreign competition to make state-owned banks more profit-oriented and efficient. The latter's partnerships with FFIs already taught them how to do this. Goldman's role in restructuring China Mobile in 1998, as well as the JV and equity-based 'strategic partnerships' between FFIs and Chinese state-owned banks should be seen in the same context. The ability and willingness of foreign actors to help the Chinese state strengthen and restructure its banking industry ultimately shut them out of playing a greater role in the Mainland financial system.

However, as the research above has shown, FFIs have played an important role in prompting elite-based internationalization, and as a result have spread Anglo-American financial practices to the Mainland in a very definitive way. This has allowed China to see the growth of a PE industry in China from the ground up, in a matter of a few short years. Foreign PE firms brought their Wall Street experience Chinese-speaking, Anglo-American-trained returnees with them, who quickly allowed FFIs to dominate the PE landscape. In bringing returnees to the Mainland, foreign PE firms effectively created linkages between these returnees and the CCP's princeling generation. This elite-based internationalization of the PE industry eventually backfired on FFIs. With nothing keeping returnees permanently employed by foreign firms, and with the Ministry of Education stepping up their efforts to lure more returnees to seek out job opportunities in China, returnees' knowledge and global connections were quickly utilized by Chinese firms. By 2010, with returnees and princelings working closely together to create a native, Chinese PE industry, FFIs found themselves facing the same systemic obstacles as those outlined in the previous chapter: limited



ability to conduct business in RMB (i.e. capital controls), an environment where privatization is (at least at the present moment in time) not wholly welcomed, if not treated with suspicion, and a general incumbency advantage by state-owned and state-connected financial institutions. These factors conspired to create what Robertson (2015) has called ‘replica’ localization in the PE industry. In the end, it was their expertise, and their staff that the CCP desired: not the FFIs’ capital, and the institutions themselves.

## Conclusion

### 1.0 Summary and Outline

What role have FFIs played in China's financial evolution since the early 1990s into the system that defines its financial landscape today? I have argued that FFIs have made significant efforts to influence the evolution of China's financial system and the process of reform and opening more broadly and that their efforts resulted in a limited but significant role in three respects. Of primary importance, FFIs have been instrumental in creating channels for the CCP leadership to outsource equity market development to global financial centers—most significantly to Hong Kong, but also to New York and later to Singapore, London, Switzerland, and elsewhere. Second, FFIs have helped to transfer Anglo-American financial expertise to China's domestic financial system in two ways: through strategic and joint venture partnerships with Mainland Chinese domestic financial institutions and by helping to create and bring back to China a class of 'returnee' financial managers and executives. Third, foreign banks have contributed to lobbying for China's accession to the WTO, which contributed significantly to the external liberalization of China's financial services.

To put it another way, foreign banks may not have driven financial internationalization in China, but without them it is difficult to see, in the counterfactual sense, how it might have preceded without them. Indeed, FFIs like Goldman Sachs, Morgan Stanley, HSBC and the World Bank's IFC were instrumental in piloting and showing the global financial community that cooperating with CCP-owned financial enterprises would yield results. Aside from a handful of sovereign wealth funds and pension funds in a select few countries, government ownership of financial enterprises was a rarity in global finance in the late 1990s, when China began to reform its banks.

Few would imagine that some of the biggest and most profitable financial enterprises in the world would be China's state-owned banks. Fewer still would know that the early capital injections and business model that allowed these banks to restructure and grow were pioneered by a small handful of American and Hong Kong investment banks. Indeed, perhaps the most understated actors in China's financial history are local Hong Kong brokerages which began to pilot Chinese government entity (Red-Chip) listings in 1990. In many ways, FFIs have piggybacked on these efforts, as well as on the efforts of Hong Kong's legislators, who made the city hospitable to a flood of Chinese SOE listings that would begin in the late 1990s. The East Asian financial crisis appeared to do more than shake up global financial markets: it helped to align the forces of global capital and Chinese communism together to help China erect some of the world's biggest companies and banks—and to keep them in state hands.

This concluding chapter will proceed in the following way. Section 2 will summarize the conceptual and empirical limitations of this thesis. Section 3 will outline the main empirical findings presented in the previous four chapters. Sections 4 will explain the theoretical implications of these findings in IPE and Chinese studies literature. Section 6 will conclude the study by suggesting some ways that the research presented here could be taken further to explore China's financial internationalization.

## **2.0. Conceptual and Empirical Limitations**

Fundamentally, the purpose of my research has been to underline the importance of the role of FFIs in China's financial evolution since the early 1990s. However, importance does not imply that FFIs played the *most* important role in this regard. As the foregoing sections will elaborate, FFIs role can only be seen to be playing a role China's financial evolution in confluence with other variables. Notably, these variables include the compromises and debates that defined

China's policy of Reform and Opening in the early 1990s, through the early 2000s—those that gave rise to China's corporate National Champions; the deliberate and decades-long development of Hong Kong as a global financial center and offshore center for the listing of Chinese state-owned enterprises and banks (including Hong Kong policymakers and local brokerages that made this possible through legislative changes and experimental listings of Chinese state assets); China's spectacular growth since the 1980s, which attracted investors to buy Chinese equities from across the globe, helped along by technological and regulatory changes that made this possible; lastly, China's accession to the World Trade Organization in late 2001, which included financial services liberalization provisions but was in no way driven by these alone, pushed China more firmly in the direction of market liberalism, with financial services bandwagoning on this broader trend.

Moreover, it is difficult to establish the precise *extent* to which FFI participation was important to China's financial evolution from a state-owned to a state-guided, but in great part market driven, financial system. While I show, with relative confidence, that FFIs played a key role as intermediaries between China's leadership and the global financial system, and that they help China's policymakers achieve a number of policy goals that helped shape the evolution of China's financial system, my research is not particularly precise about the role of FFIs relative to other foreign actors, which were not discussed at length here. For example, the role of accounting firms—particularly with respect to overseas listings of Chinese SOEs—was not explored in any great detail. This is, admittedly, a significant omission in my research. Gillis (2014) has already shown the significance of the 'Big Four' international accounting firms in building, and for the longest time dominating, China's accounting industry and profession. However, my own analysis only mentions the role of foreign accounting firms in helping Chinese leaders to outsource equity market development and in developing China's national champions.

While foreign investment banks made early national champions like China Mobile financially viable and attracted investors to purchase shares in companies that they did not (and do not) control, Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young and KPMG created balance

sheets for these companies that foreign investors could read and understand. This was, in the 1990s and early 2000s, a monumental task in a country where corporate finance was a wholly new concept and where assets and liability tracking and classification did not exist in any modern sense. As described by Gillis (2014), the Big Four were able to monopolize China's accounting industry largely because they were the gatekeepers of information that transmitted signals of legitimacy of Chinese companies to foreign investors. To put it another way, while the managerial model of Chinese companies listed abroad was the work of foreign investment banks, the balance sheets and financial information of these companies was the work of their counterparts in global accounting firms. Both aspects are absolutely essential to organizing a large corporate entity and, as such, my research has delved only into one important part of overseas listings. To give a 'full'<sup>47</sup> picture of the landmark China Telecom listing case described in Chapter 3, I would also have needed to account for the role of played by KPMG, the auditor in the IPO—not just Goldman Sachs.

It should be noted that Gillis (2014) has already done much of the groundwork in explaining how the Big Four traversed the complex regulatory environment of overseas listings and allowed Chinese SOEs to meet the capital needs of their restructuring into National Champions. Therefore, it is unnecessary to duplicate his work. But what Gillis' work does, in this case, is underscore the dangers of overemphasizing the independent agency or uniqueness of FFIs' role in this regard. Goldman Sachs was not alone in the success of the listing of China Mobile, Petro China (Diamond 2003), or other landmark SOE listings. Therefore, while underscoring FFIs' importance, it is also important to underscore the more modest aims of my research.

Similarly, in the case of transferring Anglo-American financial expertise to the Mainland financial system, the extent to which FFIs played a significant role is not entirely clear. Certainly, joint-venture and strategic partnerships with domestic banks, advisory roles to Chinese regulators—and, not to mention, the fact that many Chinese regulators have worked for FFIs abroad or in China

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<sup>47</sup> More accurately, the role of Hong Kong and US regulators, not to mention international law firms, would also need to be included in a more complete analysis of the case.

before taking on leadership roles in the CBRC, PBoC, CSRC, and other agencies—was important to the spreading of Anglo-American financial practices to the Mainland. These experiences were reflected in particular in the investment banking industry, where high profile bankers such as Liu Erfei brought back Wall Street expertise and practices to the mainland and later lured many Chinese expats working in New York and London back to the mainland to spearhead the establishment of the investment banking industry there (Zweig 2006). But emphasizing the role of FFIs' influence while de-emphasizing the agency of Chinese authorities would be inaccurate. Anglo-American financial standards and practices were, and remain in many respects, the predominant normative orientation of the global financial industry.

Industries like PE and M&A are arguably entirely the product of Anglo-American capitalism. And in the 1990s China's financial industry suffered from a lack of unified set of regulatory standards in the financial sector, and the government was motivated to organize their nascent regulatory system along Anglo-American lines because they needed *a* regulatory model, period, and the Anglo-American one just happened to be the prominent and influential (Wu and Patel 2015).<sup>48</sup> Beyond this, there is also evidence that China's government is also highly motivated to conform to global regulatory standards in the area of banking regulation to signal confidence to global financial markets or to obtain international prestige from such compliance (Kempthorne 2015). Therefore, at least in the case of PE, the success of foreign actors may be at least in part due to the fact that the global aspirations of the CCP might simply have converged with their interests and expertise.

Similarly, FFIs were invited to partner with Chinese financial institutions because they were agents of the prevailing normative structure of global finance. With respect to the influx of Anglo-American trained returnees, the return of highly skilled financial professionals to the mainland meant the influx of Anglo-American financial practices and management because the

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<sup>48</sup> Not surprisingly, enthusiasm for Anglo-American capitalism in China waned after the 2008 global financial crisis (Wu and Patel 2015).

most prestigious institutions of higher education in finance at the time were dominated by Anglo-American schools of thought. Simply put, the preferred destinations of the children of CCP cadres and newly rich Mainland entrepreneurs, not to mention the children of Hong Kong's British-linked elite, were the top business and economics schools in the US and the UK.

I do not wish to show that FFIs were responsible for the globalization of Chinese finance. Neither do I wish to show that their role was somehow more important than that of international accountants, lawyers, and others. My aims in this thesis are relatively modest: I aimed to show that FFIs played a significant role in China's financial evolution. FFIs as a variable in China's financial development should be viewed side by side with other mutually compatible variables, as illustrated above.

### **3.0. Empirical Contributions**

China's WTO accession in 2001 gave confident legal protection to Foreign-Sino financial joint ventures and allowed FFIs to incorporate their business in the Mainland. But despite the relative novelty of financial services in China and the virtual insolvency of China's financial system in the late 1990s, FFIs have held little more than two percent of the financial assets (under two percent in banking, and even less in equities) in Mainland China. From a scholarly standpoint, FFIs have continued to "disappoint[...] the hopes placed on them to become significant independent stakeholders in financial market development" (Schlichting 2008, p. 213) much as suggested nearly a decade ago by Schlichting (2008)'s research on China's financial internationalization, which looked at the first five to six years of changes since China's WTO accession. In her study, Schlichting pointed to important changes that China's financial sector had undergone since it joined the global trading system and stepped up its interaction with global financial institutions. Her study focused on the steps China's leaders had taken to introduce market liberalism into China's financial

system. She concluded that “moves towards increased market liberalisation, were not driven by the market power or lobbying efforts of foreign financial firms, but instead can best be explained by overall changes in the domestically determined priorities of the regulators.” She suggested, furthermore, that “while the actor constellation was altered, financial market development and liberalisation in China remained dominated by regulatory actors and thus was domestically determined.” (Schlichting 2008, p. 214).

My research largely confirms this part of Schlichting’s analysis. For the most part, the evolution of China’s financial system since the early 1990s has been largely internally driven. FFIs were agents of financial reform and internationalization but they were not main drivers thereof. They helped to outsource financial markets development and to transfer financial expertise to the Mainland but these changes were largely the product of policies that materialized from policy compromises between reformers and conservatives within the CCP: they were part and parcel of China’s economic planning rather than exogenous pressures. As the chapter on China’s post-WTO lobbying shows, FFI attempts to act as independent agents of change proved largely inconsequential. This stands in stark contrast with the pre-WTO lobbying stage, when their alignment with the goals of both the Zhu Rongji leadership and the Clinton administration saw China take definitive steps in the direction of external financial liberalization.

Moreover, unlike in the case of other post-communist transition economies, a large-scale transfer of banking assets to foreigners was completely avoided and in cases such as private equity, foreign predominance turned out to be a brief transition moment rather than a medium-term trend. Even after the East Asian Financial Crisis’ contagion affected China’s domestic financial institutions, what has been striking about China’s reform process, when compared with other affected emerging economies in the region, is the extent to which banking reforms in that time period were driven by domestic considerations rather than international pressures.

However, none of these conclusions suggest that FFIs’ *role* in China’s financial evolution has been inconsequential. While Schlichting is correct in her observation that FFIs were not the



main drivers of change, her analysis has some limitations. For one, it only concerns the financial industry in Mainland China—it does not discuss the changes that took place since Hong Kong’s handover to the PRC in 1998 and the crucial linkage role that the island has played between the Mainland and the global financial system. Second, it dichotomizes internationalization as a choice between accepting exogenous norms and practices, or rejecting them (this makes it similar to prominent works such as Woods 2006, Strange 1996, and Soederberg et al 2005), whereby international linkages (mainly, these linkages refer to the presence of foreign banks in China) are conduits for foreign practices, ideas, and institutions to enter and influence China without much intervention from the latter. It does not examine how these practices, ideas, and institutions are altered or contained when they enter China, and the choices made by Chinese policymakers to expose China’s domestic economy to global markets—the ‘inside-out’ process of internationalization. To put it another way, while Schlichting does an excellent job of underscoring how the pace, limitation, and direction of internationalization were driven by domestic political forces, it dichotomizes the process of internationalization, as a process that either accepts, or limits the influence of international markets and practices.

My analysis, by contrast, has shown that while the internationalization of China’s financial sector was, indeed, internally driven, it did not limit the influx of global practices and, more importantly, it did not limit China’s extensive integration with global financial markets. Rather, as Chin (2010) has shown with respect to the automotive sector, the process can be better understood as somewhere in the middle on a scale between outside-in and inside-out. Schlichtig is absolutely correct with respect to China’s domestic banking and equities markets: chapter 3 makes it rather explicit that FFIs had been demonstrably disappointed by the lack of ‘genuine’ financial opening, with the process being defined by superficial, or hollow liberalization. At the same time, she misses two important phenomena that began to take place even before much of her research carried out. First, my research has given partial support to Walter and Howie (2012)’s claim that foreign banks designed the modern Chinese state-owned corporation. It has shown how global financial giants

like Goldman Sachs, and Hong Kong's securities trading companies helped not only to outsource (Steinfeld 2010) the development of Chinese equities but helped to raise funds for and design the managerial structure of what would later become China's National Champions.

My research has also shown that, to a great extent, China's financial sector owes a great debt to the Anglo-American model of finance: whole sectors like M&A and Private Equity were lifted from Wall Street and London and transplanted to the Chinese financial landscape. However, what made China different from its Eastern European post-communist counterparts is that this transfer of technical and managerial expertise was not accompanied by a concomitant influx of foreign ownership of financial assets and banks by FFIs. Rather, strategic partnerships, joint ventures and, in the case of private equity, returnees, were utilized to help Anglo-American financial models strengthen state-owned enterprises and to create privately-owned banks and non-bank financial institutions. Of course, foreign expertise did not enter China un-altered. Given China's idiosyncratic political economy (this will be explored below with reference to the financial system), foreign practices were adopted to suit the goal of the state-economic planners, which is perhaps why Walter and Howie (2012) conclude that China's adaptation of international practices in equities and banking was shallow.

Perhaps Schlichting's biggest omission in studying China's financial internationalization was her decision to see FFIs as passive, rather than active, actors in China's process of financial liberalization. My research suggests otherwise. While FFI's role was, as mentioned above, fundamentally about helping China's leaders achieve their plans to reform and modernize state-owned companies and the financial sectors, the way in which this was done does not point to FFIs as passive intermediaries. For example, the pivotal China Telecom IPO in late 1997 owes a great debt to Goldman Sachs' work with Wang Qishan and Zhu Rongji to consolidate, centralize, and make disparate and docile state assets into a nation-wide profit-making enterprise. More importantly, the IPO surpassed global expectations despite the weak financial fundamentals and rule-bending structure of the New York and Hong Kong IPO, not to mention the extremely poor

but unavoidable timing of the process—poor because it was set in the eye of the East Asian financial storm of 1997, and unavoidable because it was on the eve of the UK’s handover of Hong Kong to Chinese sovereignty, with Zhu Rongji anxious to present at least one example of ‘One Country, Two Systems’ in practice. Goldman’s team, led by Canadian Mike Evans<sup>49</sup>, was able to sell to global investors a company that not only hitherto did not exist or run a profit, but one whose profits were *promised* and premised on the idea of China’s stellar growth and Goldman’s good name.

### 3.1. Three Channels of Influence

As the previous chapters have shown, FFIs have been involved in a number of different ways in trying to push China’s financial system to become more open to foreign capital. It is worth recalling some of the ways that foreign banks *have*, in fact, been able to influence the direction of financial reform in China. As Chapter 4 has shown, their biggest accomplishment has been to help Chinese policymakers restructure the state-owned financial and non-financial corporate sector and to raise the capital for this restructuring—all while preserving the state’s preeminent role in China’s financial sector. Indeed, as the chapter has demonstrated, foreign investment banks latched on to a golden opportunity presented to them by both changes in dynamics in global finance, as well as Chinese domestic politics, which brought about a ‘partial privatization’ compromise on the issue of SOE reform. In the case of the former, the increasing globalization of international financial centres—of financial capital more generally—as well as the growth of Hong Kong as a global offshore that allowed international actors to access China’s closed domestic markets helped foreign bankers to offer a way for Chinese policymakers to finance their financial reform scheme. But even more than simply offering financing, FFIs, beginning with smaller securities firms in Hong Kong

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<sup>49</sup> Henry Paulson recalls Zhu Rongji being so impressed with Mike Evans’s work as the executive responsible for doing the groundwork of the IPO and selecting and merging the assets that would comprise China Mobile that the former remarked: “Mr. Evans, [...] I had ten people like you I’d turn around all of the state-owned enterprises. If I had 100 people like you I’d turn around our whole country” (Paulson 2015, p. 64).

in 1990 and culminating with Goldman Sachs timely and well-executed China Mobile IPO in 1997 created a vast offshore market of Chinese securities that, to this day, is bigger than the Mainland stock markets in Shanghai and Shenzhen (Walter and Howie 2012). Further still, beyond helping to craft the off shoring of equities, investment bankers, helped along by teams of international lawyers and accountants, helped to centralize locally owned assets and to create China's present day 'national champions.

In other avenues of Chinese financial sector policymaking, FFI influence may not have been so stellar and pronounced, but it was nonetheless notable. Foreign banks introduced and taught Mainland regulators and managers the very ideas and techniques of modern financial management and investment. From private equity and M&A, to the basics of investment banking, FFI actors helped to developed financial sub-industries by leveraging the local knowledge and guanxi of returnee staff. Through joint ventures such as the Morgan Stanley-China Construction Bank partnership leading to the China International Capital Corporation, right down to the host of foreign PE firms that once dominated China's private equity, FFIs put to practice, in the area of finance, Deng's idea that capitalist tools in socialist hands can benefit China's economy. China's banking regulator, the CBRC for example, to this day consults with an external board of advisors comprised of foreign investment and commercial bankers.

Another channel of influence for FFIs has been that of lobbying. Specifically, FFIs influenced US-China negotiations on the latter's WTO accession, leveraging a number of political alliances. These included cross-issue alliances with other business groups in the US and triangular alliances between themselves, Chinese policymakers, and US policymakers. This has allowed FFIs to play a role in fostering the external liberalization of China's financial system. In view of China relatively uncontroversial compliance with its WTO commitments to liberalize the financial services sector, FFIs could be credited with helping to precipitate the formal, legal opening of this sector.

### *3.2 Architects of their own demise*

But while FFIs have been able to influence the direction of China's financial evolution in several important ways, FFIs have nonetheless failed to influence policymaking in at least one important way. Commercial banks, in particular, have failed to change the structure of the financial system in any significant way. While several interviewees in the foreign commercial banking sector in Beijing have suggested, and as the 2013 PWC report suggests, Chinese regulators are quite open to shaping policy around suggestions made by foreign bankers. However, China's Mainland commercial banking sector remains dominated by national and local banking interests and, despite the removal of legal obstacles following China's implementation of its WTO commitments in 2006, informal obstacles to FFI participation in a range of financial services in the mainland remain pronounced. The obstacles include:

- 1) A Regulatory framework that favors incumbent banks;
- 2) The dominance of bank-based lending;
- 3) The persistence of capital controls;
- 4) Close-knit relationships between large SOEs and large banks;
- 5) The underdevelopment of domestic equity markets;

These factors can be considered 'structural' because they are more broadly characteristic of China's political economy—i.e. they stretch beyond the limits of the reach of the PBoC, the CBRC, and other financial regulatory authorities.

As chapter 4 showed, there were a number of other areas of financial reform with which FFIs have not been satisfied. Costs of business concerns—difficulty applying for local incorporation licenses, long wait times for branch office expansion and product/service approval, and regulatory overlap and uncertainty—have been particularly on the rise. This has been, in part, a product of China's perhaps inadvertent yet consequential tendency to favour domestic banking institutions over foreign ones; a product of a number of policies that produce regulatory preferences

for domestic banks. And while these policies do not aim specifically at marginalizing FFIs, are certainly in conflict with the broad principles of Anglo-American market liberalism that favour FFIs.

One important aspect of such policies is China's Western Development framework (西部大开发) put in motion via a State Council-level Small Leading Group (领导小组) mandated by Premier Zhu Rongji. The policy framework is multi-faceted and includes a number of economic development areas. However, an important aspect of the plan is, of course, the flow of credit to Western provinces to finance regional development (Lu and Deng 2011). As such, it is much easier for FFIs to gain approval for branch expansion into Western provinces—that is, places where they (with the exception of HSBC) have few potential customers, poor staffing prospects, and little interest in expanding their operations (PwC 2012)—than into Eastern Provinces, where their head offices look to for expanding their China footprint. This creates long wait times for Branch office approval and approvals in locations other than those that were sought.

Similarly, interviewees have expressed, and PwC reports consistently show, that long wait times and difficulty in obtaining approval to offer a new product or service has been a consistent obstacle for FFIs. As chapter 5 showed, this is because Chinese authorities have preferred to import financial innovation by means of JV or equity-stakes partnerships between domestic and foreign banks. This makes it difficult for foreigners to go it alone and to compete with domestic banks through service and product innovation. Similarly, the policy priorities of the various regulators (the CSRC, for example, has a mandate to promote equity financing of SOEs on domestic stock exchanges—see Gillis 2014) tend to make regulatory approvals much easier for domestic banks.

As Chapter 3 explained, FFIs have been consistently unhappy that China's financial system remains defined by bank-based lending, with lobbying grievances regarding the low level of 'financial sophistication' continuing to register in Chambers of Commerce and PwC-conducted surveys. Ironically, it is the earlier success of FFIs in helping Chinese policymakers to outsource

equity market development to Hong Kong and New York that precluded greater financial ‘sophistication’ at home, despite high-level lobbying by FFIs through the U.S.-China Strategic and Economic Dialogue. A similar story can be told with respect to FFIs desire to have China lift its capital controls. In fact, since 2004, an increasing number of grievances have been registered that relate to regulations that Chinese authorities use to limit the amount of financial capital foreign institutions and individuals can bring in and of the country, including required capital reserves that FFIs must have on hand at all times (a number far greater than that domestic institutions must register).

Some FFI complaints are relatively unremarkable. For example, cost of business grievances as well as those that I placed under the category of state intervention are partially related to the close-knit relationship between state banks and SOEs. Many developmental states had exhibited such characteristics in the past and it is not strange that FFIs would be unhappy about them. FFIs are at marked disadvantage vis-à-vis domestic banks because the latter compete with a market-maker advantage in hand: they possess a nation-wide branch and regional head office network that is nearly impossible to catch for foreign institutions to match. Few corporate customers—SOEs or private companies—would thus prefer to borrow from an FFI, when state-owned banks have more capital and more locations to service them. Similarly, the dominance of bank-based lending and regulations unfriendly to foreigners are likely to be the product of China’s level of development. As Lin, Sun and Jiang (2013) have noted, bank-based financial systems carry less risks and are arguably more appropriate for low- to middle-income economies.

At the same time, it is curious that, for its level of development China appears to have such a remarkably low level of asset held by FFIs, when compared with or other middle-income post-communist transition economies or other developing countries at a similar per-capita income level (Walter and Howie 2012). But as chapters 4 and 5 of this thesis have explained, FFIs might have inadvertently made their own participation in China’s economy less necessary than otherwise might have been the case. They have done so in three ways. First, the strategy of listing shares of SOEs

in Hong Kong, New York, and later elsewhere, has allowed foreign capital markets to put pressure on them to be more efficient and gave them the necessary capital for restructuring their managerial structure. This precluded the need to use domestic equities markets for this purpose, contributing to the postponement of domestic equity market reform toward greater efficiency and market-based allocation of capital. Second, FFIs willingly participated as minority partner JV and strategic partnerships with state-owned banks. They facilitated the transfer of Anglo-American financial expertise without ceding managerial control or giving greater market share to FFIs. Lastly, FFIs facilitated the training of Chinese nationals in Anglo-American financial practices and, along with the Ministry of Education incentivized many of these individuals to return to the Mainland. Many of these returnees went on to work for state-owned and non-state-owned domestic companies, allowing the former to outcompete their foreign counterparts, as seen in the example of the PE industry, as well as in investment banking.

If the Chinese economy is to be considered ‘state capitalist,’ the research presented here suggests that FFIs—as agents of Anglo-American liberalism—may be as much complicit in this outcome as the Chinese state. Indeed, FFIs and Chinese policymakers worked hand-in-hand to bring global capital, Anglo-American expertise, and US and UK-trained staff to China’s financial system, all the while helping the state to maintain control over the levers of capital. I proposed that it might not always be appropriate to look at the history and trajectory of China’s financial reforms and the overall evolution of its financial system through the lens of financial liberalization or lack thereof, and that the framework of internationalization, as proposed for other sectors of the economy by Zweig (2002) might be a more useful framework.

#### **4.0. Theoretical Contributions**



#### 4.1 Internationalization

I also posit that our understanding of FFIs' role in China's financial system since the early 1990s yield a more generalizable framework about China's financial internationalization. I have argued that these processes of internationalization are similar to those that were first identified in Keohane and Milner (1996), but with important modifications. Drawing on Gallagher (2011), Huang (2003; 2008), Steinfeld (2010), Zweig (2002), Robertson (2015), and Chin (2010) I have proposed a new definition of the term. I have argued that internationalization need not entail changing the transaction costs of an entire sector and that policymakers can control the direction, pace and scope of the impact that global norms, practices, and incentives have on a country's economy, and the reorganization of a country's political economy that follows.

FFIs have played a role in China's financial evolution by participating in this process of internationalization. By helping Chinese policymakers to use Anglo-American financial expertise to reform corporate finance, banking, and private equity, not to mention insurance, investment banking, and a host of other sub-industries, and to fund Chinese SOEs and state banks in their time of need (in the late 1990s and early 2000s)—and to do so while maintaining state ownership over these enterprises—FFIs have, ironically, precluded the need for policymakers to give them a greater role in China's domestic financial system. This process alludes to Vernon's (1971) notion of obsolescing bargaining. This can be explained by the fact that, from a theoretical point of view, FFIs' role can be seen as one of *internationalizing* China's financial system, not *liberalizing* it. Internationalization is defined as a process of connecting a country's economy to the global economy through particular channels or linkages—through adopting international practices or by making use of globalized space, such as global cities or production chains. This is described as being distinct from liberalization, which implies the withdrawal of the state from determining market outcomes and the removal of legal, regulatory, and informal barriers to competition.

Segmented, localized opening, combined with the mobilization of elite interests and linkages has allowed China to move from a planned economy to a 'socialist market economy'

without the social unrest (always a paramount concern for the successive CCP leadership since the start of Reform and Opening) that typically accompanies post-communist market transitions. The process of internationalization—that is, the formation of global linkages between *selected* sectors (or sub-sectors), prior to wholesale liberalization—is a useful framework for understanding the role of FFI's in China's confusing and contradictory process of financial reform. It helps us to understand how China can join and implement WTO rules without sacrificing the state's dominance in commercial banking; how it can raise billions of US dollars for its state-owned companies that openly operate with soft-budget constraints and political interference, and how an industry like private equity could be created by foreigners and returned to domestic and state-owned hands in less than a decade.

FFIs have aided Chinese policymakers to help Chinese banks “link up with the international track” (Wang 2007, p. 1) without actually privatizing or opening them up to direct foreign competition. To explain this further, and drawing on Zweig's conceptualization of international linkages, I have proposed that internationalization in the area of finance is comprised of two linkages: elite-based and spatial-based. This suggests that rather than looking at areas where the state has retreated or where markets for credit or capital have been liberalized, it is best to look at areas of the financial system that have become more connected with the global financial system and the impact that this has had on the domestic economy. Fundamentally, these linkages demonstrate that it is possible to access the capital, expertise, and human resources made available by integration with the global financial system without opening the borders to free capital flows, subject domestic enterprises to global competition, and making domestic regulations more friendly to global capital.

#### 4.1.1. *Elite Linkages*

Elite-based linkages are key to understanding China's financial internationalization. In the mid-1990s, China's leaders began form important relationships with large global investment banks—notably Morgan Stanley, Goldman Sachs, and HSBC. These relationships were formed while China's economy was essentially closed to foreign investment banks altogether. But at this point, their interests converged with those of the elites in the CCP. The former had expertise in structuring successful IPOs in global financial centers while the latter sought a way to reform financially strapped and managerially inefficient SOEs. This created a convenient and timely alliance. Unlike commercial banking institutions, private equity firms, or insurers, investment banks (perhaps counter intuitively) were not, at the time, particularly interested in accessing China's equity markets: the 'real money' was in mature stock exchanges like Hong Kong and New York. But structuring IPOs and building partnerships with Chinese financial institutions was not simple: it required people that had connections in both the world of Anglo-American global finance and in China's political system as well. These early economic-political entrepreneurs paved the way for a wave of migration of American and UK university-trained Mainland 'returnees' with experience working for American investment banks.

The linkages established between international financial elites and domestic elites formed through foreign-trained members of the Chinese financial elite, which have a foot in both the international financial world and the Chinese political system, are important in explaining how FFIs have been able to convince Chinese policymakers of the usefulness of their services. As per Robertson's (2015) observation, returnees are agents of international norms and practices in finance, they also become agents of the Chinese state when they return to the Mainland, effectively *re-nationalizing* global norms and practices. Understanding the contribution to China's financial evolution made by financial returnees is key to understanding FFIs' important role in restructuring Chinese SOEs and banks. By bringing elite talent that is able to connect China's financial system with global capital and to leverage international expertise to help develop China's financial sector,

FFIs have ultimately precluded the need for policymakers to rely on foreign institutions themselves. After all, these elites are not bound to work for foreign institutions, and are frequently lured to take well-paying positions in state banks.

#### *4.1.2 Spatial Linkages*

Drawing on Sassen's (2011) notion of the global city and 'localizing the global,' and Palan's (1998) notion of offshore centers, which allow states to "have their cake and eat it too," the second pillar of linkages illustrated in my research focuses largely on how FFIs helped China to enjoy the benefits offered by the liberalized global financial system without having to fully join it. The idea of spatial linkages explains how China's policymakers used Hong Kong and New York—the latter being the most important—to raise capital for Chinese state enterprises and to put pressure on them to restructure, and how FFIs were key interlocutors in this strategy. As per the description of globalization offered by Palan, Beijing was able to access capital markets without carrying out more rapid capital account liberalization through the "bifurcation of the sovereign space" between local authority and global interconnectedness (Palan 1998). In effect, Beijing was able to use its newly re-acquired territory of Hong Kong to access global capital markets by listing SOEs—a process which the Hong Kong policymakers, select SOEs and most importantly Hong Kong-based financial institutions, already began to roll out as early as 1990.

Conceptually, the theory predicts China's experience with overseas listings via the more broadly applicable notion popularized by Sassen (2011) that globalization manifests in select localities (global cities). In other words, by re-acquiring Hong Kong and holding firmly to the policy of 'one country, two systems', Beijing was given the unique opportunity to bifurcate its own sovereignty in such a way that exposed its state-owned companies to global markets, while limiting the influx of globalization at the same time. In short, Hong Kong was China's offshore. But FFIs made it much more than that: they also made it the most important equity capital-raising centre in

the country. Simultaneously, Zhu Rongji and the pro-reform coalition in China created global linkages without taking on wide-scale privatization or capital account liberalization—aided and abetted all along the way by key FFI allies like Goldman Sachs’ Henry Paulson.

#### *4.2 Internationalization and Other Sets of Literature*

The research presented in this thesis contributes in a number of ways to existing IPE and China studies literature. To begin, the notion of internationalization presented here makes a contribution to the emerging debate surrounding Chinese ‘state capitalism,’ in which China studies scholars disagree on the extent to which China’s economic system is defined by the logic of gradual market reform or the continued involvement of the state (specifically, of the CCP) in the allocation of economic resources. The debate can be divided as that between scholars who see China’s economy progressing gradually but surely towards one defined by market liberalism (e.g. Lardy 2014; Steinfeld 2010; Green and Liu 2005; Chang and Lochele 2012) and those who see legacies of a command economy (Pei 2009; Shih 2008; Walter and Howie 2012). My research has sought to make a small contribution to this debate. I show that spatial and elite-based internationalization of China’s financial markets creates channels through which Anglo-American liberalism can influence China’s economic development in a way that, paradoxically, benefits state actors by helping them to acquire international financial expertise and raise capital abroad. I show how Gallagher’s (2011) and Huang’s (2003; 2008) studies on the manufacturing sector in China suggest that a distinction is needed between liberalization and internationalization, as defined above. This could contribute to explaining why China can appear as both state-capitalist and simultaneously headed in the direction of a market-based economy.

This thesis also contributes to the long-standing debate on the role of the state in the post-Bretton Woods era of international economic and financial integration (Strange 1996; Krasner

1999; Schmidt 2009). My conclusions run contrary to a number of studies that examine the pressures placed on emerging economies by the international system to liberalize their financial sector to FFIs (Stein 2010; Martinez-Diaz 2009; Epstein 2008, 2014; Bonin et al 2010; McDermott 2007). In one way or another, these studies show that FFIs come to own a large share of emerging market economies financial assets because the emerging economies seek the benefits economic integration, under domestic financial stress or international economic pressure, and cannot do so without ceding a significant share of national ownership. I show that China is an important exemption to this narrative. The policies pursued by China's policymakers allowed them to take advantage of international capital markets (through the process of spatial internationalization) and the financial expertise offered by FFIs (through elite-based internationalization), without foregoing capital controls or ceding a great share of China's financial assets to foreigners.

#### *4.3 The Obsolescing Bargaining Outcome and Implications for the Study of non-state actors*

This research has also sought to further our understanding of FFI lobbying by bridging the literature on the lobbying within China by various business groups (Kennedy 2008, 2009; Deng and Kennedy 2009; Pearson 1994) and the literature on FFIs' attempts to influence the character of the laws and institutions that govern international finance (Sell 2000; Woll 2006, 2012; Woolcock 1998). My study has shown that in the case of China, FFIs have leveraged a number of lobbying channels, including international (WTO negotiations and the US-China SED), as well as domestic ones, (Chambers of Commerce lobbying and direct firm-to-government lobbying) to influence the way that China's financial regulatory system treats foreign firms in the financial sector. I described these as important aspects of China's elite-based internationalization. I concluded that their lobbying efforts have largely been hampered not by their lack of success but by the five informal obstacles to their participation in the financial system (listed in section 3.2 of this chapter), which

they have inadvertently helped to create. This, in effect, has led them to be in a position of obsolescent bargaining, vis-à-vis the CCP.

My research also contributes to the research in IPE that looks at the role of non-state actors in the global economy. Some of this literature concerns the ways in which ideas embedded and promoted by international organizations spread to, and are adapted by, emerging and post-communist economies. (e.g. Chwieroth 2007a, 2007b, 2009; Herrera 2010); how epistemic communities globalize particular kinds of policy practices (e.g. Adler and Haas 1992); and the ways in which policies and practices are altered and localized within particular national contexts (Acharya 200, 2004). My research shows how predominant global policies and norms in commercial banking, finance, insurance, and private equity have spread to the Chinese financial landscape; and how they were altered and localized. My study utilizes Robertson's (2015) research and broadens it to show how the elite-level connection between the CCP's princelings and the global financial elite have helped to internationalize China's financial sector (via elite-based internationalization), while paradoxically keeping it insulated from the vicissitudes of global capital all at once.

## **5.0. Final Thoughts and Directions for Future Research**

This concluding chapter has emphasized the limitations of my research and has noted that FFIs' role in China's financial evolution, as described here, should not be overstated. Besides the reasons noted above, we should also consider a number of limitations that, while perhaps beyond the scope of the present research, may help to illuminate some points of confusion and unanswered questions that may have arisen throughout this thesis. To begin, while the first two empirical chapters (2 and 3) are devoted to the subject of FFI lobbying, there is no clear line linking cause

and effect between lobbying and policy outcomes. Of course, establishing a clearer picture of the impact of lobbying on China's policy would have made FFIs' role in China's financial evolution far clearer, and would have likely made a more certain contribution to the existing literature.

While this is an enormously difficult task with respect to chapter 3, largely because FFIs are not known to lobby as a group and because the impact of any on FFI's relationship with the government is difficult to qualify or quantify, it is quite feasible to better substantiate FFIs' role in Washington's WTO negotiations with China, as described in chapter 2. Because financial services liberalization was not a big issue in China's trade negotiations with the US, the available information on FFIs' role in these negotiations is rather sparse. I have used the best publicly available evidence, as found in congressional testimonies and media reports. However, additional interviews with former US trade negotiation staff, with representatives of the US financial industry at the time, and with parties opposed to China's WTO membership—labour, human rights, and environmental groups—would certainly paint a much clearer picture of the lobbying tactics used by FFIs at this time. This would help us to answer a number of relevant questions about FFIs' role in China's financial evolutions. How important were FFIs in pushing for China's WTO accession? What role, if any, did US-based investment banks' desire to list Chinese enterprises in New York and Hong Kong play in FFIs support for China's WTO membership? Did FFIs' support for China's WTO membership grant them any policy concessions on the part of the Chinese leadership with respect to financial services liberalization? Lastly, how did non-US firms use the US-China WTO negotiation process—specifically, the Financial Services Committee of the Coalition of Service Industries—to push for China's WTO accession? The 1997-1998 East Asian financial crisis certainly played an important role in China's external financial liberalization process (Schlichting 2008). Did US-China WTO negotiations push Chinese policymakers to open the financial sector even further than would have otherwise been the case?

With respect to the listing of Chinese firms abroad, my research relied heavily on the China Telecom/China Mobile listing led by Goldman Sachs. This was also, regrettably, a choice of



convenience, because of the sufficient amount of publicly available information on the landmark listing. However, there were other important listings that this thesis did not explore in detail. For example, we know from Diamond (2003) that the PetroChina listing on the NYSE came at the end of a long legal and political battle, the result of which was perhaps equally consequential to the China Telecom deal. Looking more closely at this landmark deal, as well as others that followed it shortly thereafter would give us a better picture of how FFIs helped to solidify the presence of Chinese SOE equities on the NYSE despite widespread labour, human rights, and environmental opposition thereto. It would also give us a much better picture of the extent to which FFIs have actually contributed to Zhu Rongji's agenda of restructuring Chinese SOEs.

As such, while this research has begun to make scholarly contributions in this regard, there are several additional areas where more robust empirical work could be done. For instance, while Chen (2013) and myself have shown that international financial centers have played a significant role in China's financial internationalization by helping create a market for Chinese equities abroad, what has been missing in Chen's analysis and this thesis is the ways in which international law firms and policymakers in these financial centers have sought out Chinese SOEs to list in their stock exchanges. While my research in chapter 4 touches on the role played by Hong Kong's policymakers, a more robust account of China's financial internationalization would explore the different policy approaches taken by regulators in the city, as well as by regulators in other global financial centers like New York, Singapore, London, Luxembourg, and elsewhere. Similarly, the existing literature rarely accounts for the important role played by international lawyers in helping to convince these regulators to allow for Chinese firms to list by advising Chinese SOEs regarding the appropriate place of incorporation and the appropriate method of balance sheet disclosure. In a related way, this also underscores the important contribution of offshore centers like the Cayman Islands (where many Chinese companies are incorporated before listing abroad) in helping Chinese companies raise capital and become the National Champions we know today.

Lastly, it should be noted that the theoretical framework developed in this thesis applies largely to China, due to its size and importance in the global economy. The elite-based linkages described throughout the empirical chapters are unlikely to be observed in other countries. FFIs went out of their way to court Chinese officials, to engage in bidding wars and in partnerships with firms that they ultimately did not and would not control. However, spatial linkages are an area of internationalization that could certainly be observed in other jurisdictions. After all, China is not the first country to see a large share of its companies' equity be listed on global stock exchanges. In this regard, IPE literature has plenty of room to explore the ways in which policymakers in jurisdictions with under-developed equity markets have sought out global financial centers to help their state-owned or private firms meet their capital needs. And, of course, in all these cases, scholars should be wary of neglecting the important role played by FFIs in helping to create these spatial linkages.

Moreover, the preliminary findings in chapter 3 provide potentially significant lessons for countries that seek foreign capital and look to liberalize (or further liberalize) their economies (for instance, Vietnam, or perhaps even Cuba); and, not to mention, retrospective lessons for examining financial reforms in post-communist transition economies. My research has suggested that, while FFIs are certainly interested in greater financial liberalization in their target markets, if only for the simple reason that such reforms are likely to earn them higher returns in those markets,<sup>50</sup> it is not necessarily the case that they will be uncooperative partners in a more idiosyncratic trajectory of reform—as long as some market access is provided in the process. Moreover, my research certainly does not point to an image of FFIs as a coherent block of agents of global capitalism. Indeed, their lobbying in China has, if anything, lacked a significant degree of collective action that may have

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<sup>50</sup> It should be noted, however, that the author's interviews with FFI representatives in China did not provide a coherent picture of FFI goals with respect to financial liberalization. Commercial bankers, for instance, are certainly eager to see foreign ownership restrictions lifted. Investment bankers, however, have been quite comfortable helping Chinese state-owned firms raise money abroad, even if this means sacrificing the chance to have a greater market share in domestic financial markets.

provided them greater influence vis-à-vis Chinese policymakers. While FFIs have certainly been effective allies of financial liberalization-oriented Chinese leaders, the actual process of liberalization has been domestically-driven, with the spatial and elite-based linkages fostered through policymaker-FFI interactions making financial reform more tenable, but not determining the course thereof.

These findings also speak to a theme emphasized in the introduction, that China's experience with FFIs speaks more to the character of the global financial system than to the character of China's financial reforms. As the case of the latest Chinese bank IPOs (e.g. the Agricultural Bank of China), as well as the recent listings of Chinese AMCs in Hong Kong, illustrates, the global financial system might have an intrinsically liberal, Anglo-American character, but it ultimately does not necessarily preclude alternative, non-liberal financial sector policies. This is the case so long as these policies create viable linkages between agents of the global financial system and the economy in question, in some way. As Sassen (2011) has observed, global economic processes and practices manifest in distinct ways, and are influenced by the character of concentrated locales of economic activity—the global cities. In this respect, China benefited from the social and commercial ties that began to form between Hong Kong and the Mainland in the 1990s, as well as from the friendships between high-ranking CCP officials and Wall Street bankers. And while China's historical circumstances and experiences cannot serve as a directly applicable blueprint for other transition and emerging economies, they do provide policy options for policymakers in these countries. Namely, China's case suggests the option of utilizing global cities and forward-looking Wall Street elites to allow policymakers to 'have their cake and eat it too': to realize the benefits of liberalized global finance without liberalizing their respective domestic financial systems along the blueprints suggested by the Anglo-American policy paradigm.

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