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The Globalisation of China's Financial Sector: policies, consequences and lessons

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Abstract

The variety of country experiences with financial sector globalization has precipitated the emergence of a large literature discussing policies, consequences and lessons learned. China's policies and performance makes an important contribution to this discussion. In contrast to many of its neighbours, China maintains a relatively detailed system of capital controls. During the Asian financial crisis that sent most countries in the region into negative rates of growth, China continued to expand rapidly despite having a financial system that by most objective measures was the worst in Asia. This apparent contradiction has led many researchers to argue that an explanation must lie in China's usage of capital controls. This paper first reviews the policies that China has undertaken toward the globalization of its financial sector. The consequences of these policies are then summarised and policy implications are drawn for other countries embarking upon the path of financial sector globalization. It is emphasized that while China makes extensive use of capital controls, many have readily been circumvented resulting in considerable *de-facto* external financial liberalization. Therefore, the claim that capital controls are the reason behind China's impressive growth performance should not be over-stated.

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1. Introduction

Economists have traditionally envisaged the globalisation of a country's financial sector as being a growth-promoting process. For countries with a domestic savings shortfall, such a policy path provides access to a larger pool of capital and at a lower cost than would be possible from domestic sources alone. Similarly, surplus countries can lend abroad and receive a higher rate of return than would be possible from relying on domestic investment opportunities alone. Furthermore, there are also dynamic benefits as a country's domestic financial institutions and markets are exposed to heightened competition and international best-practice management and technology. This theoretical basis provided the rationale for the trend towards financial sector globalisation that began in many countries during the 1970s.

The observed outcome of such globalisation however has been mixed. On the one hand, cross-country econometric evidence has generally been favourable (Levine, 2001). Nevertheless, examples of apparent failures can readily be cited. Since the mid-1990s at least six countries / country blocs have experienced a financial and economic crisis as capital has been rapidly withdrawn from the domestic economy and moved abroad (Salvatore, 2003). These have included Mexico (1994-1995), South-east Asia (1997-1999), Russia (1998), Brazil (1999) and Turkey and Argentina (2001-2002). It is important to recognise that crises associated with financial sector globalisation contain a harsh human dimension, with research showing significant increases in poverty associated with such occurrences (World Bank, 2000).

The variety of country experiences with financial sector globalisation has precipitated the emergence of a large literature discussing policies, consequences and lessons learned. China's

policies and performance vis-à-vis other developing and transitional economies, particularly in the period leading up to and during the Asian financial crisis, has occupied a prominent place in this discussion. Whereas its neighbours fell into negative rates of growth, China's economy grew at an average annual rate of 8.4 percent during 1997-1998. This was despite the fact that China's financial sector at the time was described as having "The worst banking system in Asia" (*The Economist*, 02/05/1998). The attempt to reconcile these seemingly contradictory facts has primarily focused on the policy mix adopted by China towards the globalisation of its financial sector. In contrast with other countries in the region that had earlier undertaken comprehensive external financial liberalisation, China maintained a relatively detailed system of capital controls. Yu (2000) expresses orthodoxy in contending that it was this system of capital controls that was responsible for China's superior performance during the Asian financial crisis. Indeed, other crisis-affected economies such as Thailand (1997), Malaysia (1998) and Brazil (1999) have since experimented with reinstating capital controls that had earlier been removed as part of their own moves towards financial sector globalisation (Edison and Reinhart, 2001).

The globalisation of China's financial sector has also attracted increased attention since its WTO entry in 2001. This is because China's WTO accession agreement was notable for the fact that it contained large concessions relating to services, in particular financial services. It also meant that the globalisation of China's financial sector would now proceed according to a set timetable. For example, five years after accession, foreign banks in China will be afforded full national treatment. This reality has been met with both optimism and concern. On the one hand, foreign financial institutions are enthusiastic about the prospect of gaining greater market access. On the other hand, there is concern, particularly amongst China's neighbours, that the globalisation of

China's financial sector will mean that less foreign capital will flow into their own economies. On the domestic front, the Chinese government is using its WTO commitments as a means to push forward its financial sector reform agenda, which has generally lagged behind the progress made in other sectors of the economy. Increased competition from foreign financial institutions and the possibility of joint ventures and technological tie-ups could indeed promote greater levels of efficiency in domestic financial institutions. The chief risk associated with increased competition from foreign banks is the possibility of a liquidity crunch in the state banking system. That China's state banks have had a negative net worth since the early 1990s is well known (Lardy, 1998). However, they have been able to remain liquid because the household sector, with few other investment alternatives, has continued to build up their holdings of savings deposits. If in the future these savings were channelled into foreign financial institutions, the precarious viability of the state banks could be exposed.

The second section of this chapter chronicles the policies that China has employed toward the globalisation of its financial sector since the Open Door Policy began in 1979. Policies are grouped under three headings; the growth of foreign banks, the liberalisation of capital controls and exchange rate reform. Section three discusses the consequences of polices that China has adopted and considers the lessons that can be garnered for other countries also undergoing financial sector globalisation. Section four summarises the findings and makes concluding comments.

2. Policies towards financial sector globalisation

The growth of foreign banks [2]

Foreign banks were initially confined to entering China in the form of representative offices, which meant they were not able to undertake activities directly related to generating a profit. They were also confined geographically to Beijing and the Special Economic Zones (SEZs) (*ACFB 1992*). During the mid-1980s regulations were introduced that allowed foreign banks in SEZs to begin increasing their business scope, such as enabling them to engage in profit-making activities including loans, deposits, guarantees and remittances (*ACFB 1991*). However, these regulations confined foreign banks to providing these services only if they were in foreign currency and involved foreign entities (individuals, companies, embassies, etc) (*ACFB 1992*). Thus, foreign banks continued to be entirely segmented from providing financial services, in both foreign and local currency, to Chinese individuals and companies. Geographical restrictions were gradually relaxed in the late 1980s and foreign financial institutions began to establish in other relatively open cities such as Tianjin, Nanjing and Fuzhou. In 1994, the first national regulations since 1982 were released that formed the legal basis by which the People's Bank of China could examine, approve and control foreign financial institutions (*ACFB 1995*). This document retained restrictions over the operations of foreign banks and detailed what many foreign institutions have considered onerous requirements for setting up in China, particularly in light of their limited business scope. For example, before a foreign bank could apply to establish a branch in China it must have maintained a representative office for at least two years. In addition, the total assets of the applicant had to be greater than USD20 billion. The year 1996 marked the first time that foreign banks were permitted to provide any sort of local currency RMB business (*ACFB 1997*). In a pilot project selected foreign banks located in the Pudong

[2] The discussion in this chapter is restricted to foreign banks. Other foreign financial institutions such as finance and insurance companies are left to be discussed in future work.

district of Shanghai were allowed to accept RMB deposits from foreign individuals (who had lived in China longer than one year), foreign enterprises (including those from Hong Kong SAR and Macao SAR), or re-deposits of their RMB loans to non-foreign funded enterprises. Similarly, they were allowed to offer RMB loans and provide guarantee services to foreign enterprises or non-foreign funded enterprises that had received their foreign currency loans or guarantees (Bonin and Huang, 2002). This scheme gradually expanded and at the time of WTO entry in 2001 there were 31 foreign banks approved to offer such services, of which 23 were located in Shanghai and 8 in Shenzhen. The total RMB assets of these banks had reached RMB45 billion (*ACFB 2002*). The asset share of foreign banks however remained meagre as they accounted for less than two percent of the total assets of China's banking system. Their share of the RMB market was even smaller. For example, at year-end 2001 foreign banks held only 0.34 percent of the RMB loans market (*ACFB 2002*).

WTO accession committed China to greatly expanding the business scope of foreign banks. Table 1 is based on Bonin and Huang (2002) and summarises China's WTO commitments in the banking industry.

Insert Table 1 here

Upon accession, China cancelled geographical and client limitations to approved foreign banks in handling foreign exchange business. This meant that these banks could provide foreign currency services to Chinese enterprises, whereas previously they had been restricted to servicing only foreign individuals and enterprises. Accession also meant that in the first wave of financially open cities (see Table 1) approved foreign banks were able to provide RMB services to foreign companies and individuals. Previously such activities had been undertaken only on a

pilot basis in Shanghai and Shenzhen. As of end-October 2003, 84 of the 191 foreign banks in China held an RMB license (*People's Daily*, 11/12/2003). One of the most significant events since WTO entry occurred in late 2003 when foreign banks that held an RMB license were also permitted to apply to handle RMB business with Chinese enterprises in the 13 cities that had been declared financially opened by this time (*People's Daily*, 01/12/2003). This marked the first time foreign banks had been permitted to provide RMB services to Chinese enterprises. In January 2004, four foreign banks were given approval to begin such business (*People's Daily*, 12/02/2004).

Yet, despite such instances of banking sector globalisation, the asset share of foreign banks in China has failed to increase measurably in the immediate years following WTO entry. At end-October, 2003 the total assets of foreign banks in China were USD46.6 billion, which only accounted for 1.4 percent of the total banking assets in China (Liu, 2003). Several factors have been put forward to explain why foreign banks have yet to become significant players in China's domestic financial sector. First, during the five-year phase in period many foreign bank activities remain subject to restrictions, as does their geographical location. Through 2004, foreign banks still cannot provide RMB services to either foreign or domestic entities in most cities in China. This means they remain segmented from the 1.3 billion people, RMB1200 billion local-currency savings market (*The Banker*, 03/11/2003). Second, the approval process for foreign banks to expand their operations is extremely slow. For example, foreign banks have to wait 12 months after a branch license has been issued before they can apply to open another branch. This has meant that even the largest foreign bank in China, Hong Kong and Shanghai Banking Corporation (HSBC), has a network consisting of only nine branches. This is in contrast to the

Industrial and Commercial Bank of China, the largest domestic bank in China, which has 8800 branches (*The Banker*, 03/11/2003). Third, to apply to undertake RMB business a foreign bank branch must have made profits in two consecutive years of the three prior to its application.

The gradually deepening globalisation of China's banking sector has also prompted China's regulatory authorities to conform to international norms regarding the prudential control of financial institutions. In 2003 the China Banking Regulatory Commission (CBRC) announced that new regulations on capital adequacy standards for commercial banks would be introduced based on the original 1988 version of the Basel Accord, an international convention on financial institution risk management (*China Daily*, 15/08/2003)[3]. As part of this process, in January 2004 two state banks, the Bank of China and China Construction Bank, received a fresh capital injection of USD45 billion as part of a pilot program to bring their capital adequacy ratio above the eight percent required by the Basel Accord and prepare them for public listing in the near future (*People's Daily*, 10/02/2004). From 2004, China's state-owned commercial banks and joint shareholding commercial banks will also adopt the internationally accepted five-category loan classification system that grades loans as being either Pass, Special-mention, Substandard, Doubtful and Loss (*People's Daily*, 06/09/2003).

An increasing number of foreign banks have also been given permission to buy stakes in Chinese banks. HSBC became the first foreign commercial bank after WTO entry to take an equity share in a domestic lender when it purchased an eight percent stake in the Bank of Shanghai in late 2001 (*People's Daily*, 07/01/2002). In addition, China's asset management companies and banks

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[3] China's regulatory authorities have also stated that they will not be seeking to implement the new version of the Basel Accord due to implemented in G-10 countries in 2006.

have been forming joint ventures with foreign financial institutions in an effort to sell off the large volumes of non-performing assets sitting on their balance sheets (*People's Daily*, 03/12/2002; *People's Daily*, 09/07/2003). China's domestic banks have also been active in undertaking offshore expansion. At year-end 2001, domestic Chinese banks had established 452 banking institutions overseas that held total assets of USD151 billion. The bulk of this expansion was in the Hong Kong and Macao Special Autonomous Regions, which accounted for 374 of such institutions and assets of USD117 billion (*ACFB 2002*).

Liberalisation of capital controls

China's Open Door Policy signalled a new willingness on the part of the government to use foreign capital to fund domestic investment. During the 1980s the majority of this capital came in the form of foreign loans, and official donors such as foreign governments and international organizations such as the International Monetary Fund and the World Bank featured prominently. These loan inflows averaged around one percent of GDP, with a peak of 1.68 percent in 1990. Foreign direct investment (FDI) was significant and increasing during the 1980s but never exceeded one percent of GDP (Laurenceson and Chai, 2003). National stock markets were not established until 1991 and hence there was no foreign portfolio investment to speak of.

While FDI trailed foreign loan inflows during the 1980s, polices that liberalized FDI in the early 1990s contributed to FDI inflows averaging around 4 percent of GDP during the 1990s, with a

peak in 1994 of 6.22 percent[4]. In 2002, China absorbed more FDI than any other country in the world, including the U.S (*People's Daily*, 02/01/2003). Policy liberalisation included -

a. decision-making power with respect to the screening and approval of FDI gradually moved away from the central government towards local and provincial-level governments (*ACFERT 1985*; *ACFERT 1997/8*).

b. ownership restrictions were relaxed away from joint-venture requirements and an increasing proportion of FDI came in the form of wholly owned foreign enterprises. During the period 1979-1983, wholly owned foreign enterprises accounted for only three percent of FDI inflows. By 1997 this share had grown to 36 percent (*ACFERT 1997/1998*)

c. managerial autonomy increased over time relating to factors such as input, output, pricing and financial decisions (Chai, 1998).

d. incentives were provided such as offering concessions on customs duties, industrial and commercial taxes, income taxes and taxes on profit remittances (*ACFERT 1985*). They also included reduced fees for land use, labour services and other public utilities (Chai, 1998). While these incentives were initially confined to FDIs located in SEZs, over time they become more widely available, particularly to those cities and provinces located in the coastal regions (Lardy, 1995).

e. sectoral controls were relaxed and China began to open up its services sector including banking, retailing and telecommunications, as well as major infrastructural activities (Chai, 1998).

[4] It should be noted however that a significant proportion of this FDI could in fact be capital of Chinese origin seeking to take advantage of concessions extended to FDI. Lardy (1995) reports that the World Bank in 1992 guessed that round-trip capital might comprise as much as 25 percent of gross investment inflows into China.

Aside from FDI, the formation of national stock markets in 1991 made it possible for foreigners to undertake portfolio investment in China. Nevertheless, foreigners were only permitted to purchase equity in Chinese companies listed on the B-share market. The A-share market, which contained a greater number of listed companies, was reserved solely for Chinese individuals and companies. Controls over other types of capital flows, such as foreign loans and Chinese investment abroad, remained largely in place (see Yu, 2000 and IMF, 2003).

The presence of capital controls however does not necessarily imply that they have been effective in restricting capital flows. There is growing empirical evidence to suggest that China's capital controls have become increasingly porous over time. For example, despite the requirement that foreign loans be approved and registered, during the 1990s many of China's non-bank financial institutions borrowed heavily from abroad and even the SAFE acknowledged that regulations were regularly being flouted (*ACFERT 1992/3*). The bankruptcy in 1998 of Guangdong International Trust and Investment Company (GITIC), then one of China's largest non-bank financial institutions, is instructive. GITICs experience mirrored the situation of many financial institutions throughout Asia where a combination of moral hazard and lax prudential frameworks led to a rapid expansion in borrowing to fund largely speculative investments. GITIC, for example, became the largest property developer in southern China (*The Economist*, 16/01/1999). At the time of its bankruptcy GITIC had USD1.2 billion in registered foreign currency borrowings (*Time International*, 01/02/1999). GITICs total foreign borrowing however far exceeded this official amount. By the end of liquidation proceedings it was revealed that GITIC had debts amounting to USD3 billion, of which 80 percent came from over 130 foreign banks (*Xinhua News Agency*, 28/02/2003). Similarly, capital controls designed to prevent

Chinese capital from moving abroad have met with only limited success as several studies have documented large and increasing volumes of capital flight exiting China (Gunter, 1996; Wu and Tang, 2000). Chai (1994) and Lardy (1995) were amongst the first to note that for much of the reform period China has in fact been a net capital exporter. McKibbon and Tang (2000) quote World Bank data and assert that in 1995 China was already the eighth largest capital supplier in the world and the largest one among developing countries.

Exchange rate reform

At the start of the Open Door Policy the RMB was not convertible and highly overvalued being set at around RMB1.5 / USD (Chai, 1998). In 1981 a shadow exchange rate, known as the Internal Settlement Rate, was introduced alongside the official rate and was calculated from the average cost of earning a dollar through exports and was set at RMB2.8 / USD. This represented an effective devaluation of the RMB by 50 percent for trading enterprises. Further devaluation then took place on several fronts. Firstly, the official exchange rate was devalued on numerous occasions. In 1985 the official exchange rate was aligned with the Internal Settlement Rate at the time, RMB3.71 / USD. Secondly, the official exchange rate experienced downward pressure through the introduction of swap markets for foreign exchange, where companies, and later, individuals, could sell surplus foreign currency at rates that were determined by demand and supply forces. It has been estimated that by 1992 the share of foreign exchange traded at the market rate was 80 percent. In 1994 the official exchange rate was abolished and unified with the swap market exchange rate. Chou and Shih (1998) show that while the RMB was considerably overvalued in the early stages of the reform period, it had largely come to reflect its equilibrium value by the 1990s. Since the mid-1990s China's exchange rate system has been a managed

float, whereby market forces nominally determine the exchange rate in the interbank foreign exchange market. It is however a dirty float in the sense that daily movements of the RMB/USD exchange rate are limited to 0.3 percent on either side of a basic rate announced by the central bank. The daily movement of the RMB versus the Hong Kong dollar and Japanese yen is limited to one percent (IMF, 2003).

In 1996, the RMB became convertible for current account transactions. This watershed was reached earlier than expected with officials and commentators in 1993 discussing a ten-year time frame. Tsang (1997) at the time made the point that unless current account convertibility was tied to liberalisation of the trade control system (such as a reduction in tariffs, quotas, licenses, etc) it would be of little practical relevance. Subsequent years have revealed that China has made enormous progress in this respect, even prior to joining the WTO. Lardy (2002) for example states:

"By the eve of its entry into the World Trade Organization the average statutory import duty rate was only 15 percent, two-thirds less than the peak level of the 1980s. More important, by the second half of the 1990s actual import duties were only a small fraction of the average statutory rate. Similarly, by the eve of China's accession to the World Trade Organization, the state had reduced the number of imports restricted by quotas and licenses by 80 per cent compared with the early 1990s. Only 4 percent of all tariff lines remained encumbered by import quotas and licenses".

In 1997, following on from the earlier than expected achievement of current account convertibility, China's leaders announced the goal of achieving capital account convertibility by

year 2000 (Groombridge, 2001). The events of the Asian financial crisis however saw this goal being dropped from the immediate policy agenda. Nonetheless, Hu (2001) argues that the achievement of current account convertibility and WTO accession amounts to significant de-facto capital account convertibility. For example, one of the most popular methods for Chinese companies to illegally move capital abroad has been through the misinvoicing of trade (the over-invoicing of imports and under-invoicing of exports). The achievement of currency convertibility for current account transactions, and WTO-mandated trade and investment liberalisation more generally, has only served to make this process easier. The most significant official move towards full convertibility since WTO entry has been the introduction of the Qualified Foreign Institutional Investor (QFII) scheme. This gives approved foreign institutional investors limited access to the A-share market. A QFII can apply for a foreign exchange quota to be used for securities investment ranging from USD50million to USD800 million. As of October 2003, nine QFII licenses had been issued and in aggregate these foreign institutional investors received an investment quota of USD975 million to buy A shares, bonds and mutual funds (*China Daily*, 25/10/2003).

3. Consequences of China's policy approach and lessons

Given that China is still in the midst of the globalisation of its financial sector, the consequences of some policy choices, particularly those implemented after WTO entry, remain unclear. It is still too early to discuss the consequences that removing restrictions on foreign banks will have on the efficiency and stability of the domestic financial sector[5]. What follows therefore is a broad

[5] Bonin and Huang (2002) attempt to shed light on this topic by considering the experience of the transitional economies of eastern and central Europe and what this will likely mean for China.

sketch of some of the major identifiable consequences of China's policies to date, and where possible lessons for other countries also undertaking the transition to a globalised financial sector are drawn.

a. The combination of capital controls and the lack of full RMB convertibility has contributed to a rapid increase in domestic financial depth and reduced China's reliance on foreign capital.

China's financial depth (measured as broad money minus currency in circulation divided by nominal GDP) increased from 19 percent in 1978 to 134 percent in 2000 (Laurenceson and Chai, 2003). This meant that during the reform period China has been able to match investment rates ranging between 30-40 percent of GDP with domestic savings rates of the same magnitude. In 2001 the average external debt stock relative to gross national income ratio amongst developing countries was 118.5 percent. In China the comparative figure was just 15 percent (World Bank, 2003). This assertion does however need to be qualified as other, possibly more important factors, have also been responsible for increases in financial depth such as the maintenance of positive real interest rates and increasing financial institution density (Laurenceson and Chai, 1998). Furthermore, as noted above, controls over Chinese capital moving abroad appear to have become less effective over time.

It is not possible to come to definitive conclusions regarding the value of policies that have reduced China's reliance on foreign capital. On one hand, public policies that have promoted high domestic savings rates have been identified as contributing to the rapid rates of capital accumulation and economic growth that has been observed throughout the Asian region during

the post-war period (World Bank, 1993). Furthermore, it may be argued that such policies have helped China avoid a "foreign debt trap" of the type experienced by other developing countries (McKinnon and Pill, 1996). Yet, according to economic theory, there is no particular benefit intrinsically linked to funding investment through domestic savings. Indeed, if domestic savers can achieve higher rates of return from investing abroad, or domestic investors can attain funds at a cheaper rate abroad, then such policies could well be welfare reducing.

Another consequence of the increase in financial depth has been that the Chinese government has earned considerable seigniorage revenue (Kime, 1998). This is important in the context of a transitional economy, which tends to lose it traditional tax base in the move to a market economy (McKinnon, 1991) and China is no exception (Wong, et al., 1995). The collection of seigniorage revenue further reduced China's need to borrow from abroad.

b. The removal of controls on FDI, while maintaining relatively tight controls on foreign borrowing and portfolio investment, has contributed to the stability of foreign capital inflows into China.

FDI involves a long-term commitment to the host country through a physical presence. FDI also carries the added benefit that it usually includes the export of technology (broadly defined) whereas foreign loans and portfolio investment are solely financial in nature. The development benefit to China from FDI has been well established (Kueh, 1992). This stability of foreign capital inflows was never more evident than during the Asian financial crisis (Table 2). The affected economies experienced plummeting exchange rates and large net outflows of highly

liquid capital such as short-term debt and portfolio investment. China also experienced net outflows of these types of capital but was far less exposed. While acknowledging the role played by capital controls in providing a stable supply of foreign capital inflows, it is equally important to restate that controls over Chinese capital moving abroad were of limited effectiveness. Thus, the general role of capital controls in shielding China from the instability of the Asian financial crisis should not be overstated.

Insert Table 2 here

China's policy of discriminating in favour of FDI could well offer lessons for other countries. The stability of capital inflows is important, particularly if it is accepted that highly liquid capital flows are vulnerable to market failure such as herding behaviour and contagion effects. It is also the poor who are disproportionately affected by rapid capital outflows and exchange rate depreciation if a large proportion of basic necessities are imported.

Retaining controls over foreign loans and portfolio investment is a specific example of China's overall approach to financial sector globalisation of gradualism. There is a long history of debate in the literature of financial sector globalisation regarding the relative merits of gradualism versus a "big bang" approach (Tsang, 1997). China's experience lends credence to the benefits of a gradual approach. It is hard to conceive that China could possibly have grown even faster had it pursued a more "big bang" approach. Also, if the relative "big bang" approach to financial sector reform taken by transitional economies in Eastern Europe during the 1990s serves as any sort of counterfactual to China's experience, then China's subsequent superior economic performance is instructive. IMF (1999) shows that over the period 1991-98, inflation in China averaged 9.5 percent annually, compared with 130 percent in the transitional economies of central and eastern

Europe. The average growth rate of real GDP over the same period was 10.8 percent in China compared with –2.0 percent in the other transitional economies. Gorton and Winton (1998) further note that financial sector reform in most transitional economies has gone hand in hand with increased instability and virtually all have experienced some form of banking crisis. Scholtens (2000) adds that the financial sector in most transitional economies remains shallow. China has so far avoided a financial crisis and the World Bank (1996) reports that although most transitional economies had a similar level of financial depth during the late 1980s, by the mid-1990s China's level of financial depth was more than double that of the transitional economies in central and eastern Europe. The benefits of gradualism are theoretically grounded in the notion of second-best. That is, while complete liberalisation may be optimal in a world of complete and perfect markets and institutions, the absence of one or more of these conditions provides a rational for government intervention. Controls over highly liquid capital flows are a prime example. Due to the fact that these types of capital flows are vulnerable to market failure, their productive usage is contingent upon the existence of a highly competent prudential framework. In the absence of such a prudential framework, capital controls could constitute an optimal policy in a second-best sense[6].

This is not to suggest that specific policies such as those that favour FDI or the gradualist approach in general come without cost. For example, controls over foreign loans and portfolio investment have likely come at the cost of reduced access to investment capital for China's emerging private sector. Despite high overall rates of domestic savings and investment, the private sector has often had difficulty in accessing external financing because the state banking

[6] Laurenceson and Chai (2003) discuss several prerequisite conditions that are needed before China can undertake full-scale external financial liberalisation.

system has channelled the bulk of household savings towards state-owned enterprises (Gregory and Tenev, 2001). It is also worth noting that other countries may not achieve the same degree of success China has had simply by copying its policies. Due to its enormous market potential, China has been able to attract large volumes of foreign capital in spite of the existence of controls over foreign loans and portfolio investment. Other countries may suffer a greater opportunity cost in terms of foregone investment if similar policies were implemented.

c. Policies that have liberalized coastal cities before the inland regions have contributed to the bulk of foreign capital being directed towards the coastal region.

Globalisation in itself would naturally lead to China's coastal regions receiving a disproportionate share of foreign capital due to their strategic location for trade and investment. Policies that have first liberalized coastal cities have exaggerated this effect. This has important implications because an empirical link between globalisation (of trade and finance) and growing regional income inequality in China has been found by several recent studies (Jones, et al., 2003; Zhang and Zhang, 2003). This is not to say that globalisation has contributed to absolute income declines in the central and western regions but rather that it has contributed to coastal cities growing relatively fast. Thus, opening up the coastal regions first has further worsened regional income inequalities. The lesson for other large countries in this respect is self-evident. In the interests of promoting sustainable growth, governments need to better manage the distributional consequences of globalisation, not exaggerate them.

4. Conclusion

China’s policy approach to financial sector globalisation has differed from both its neighbours in Asia and other transitional economies in Europe. Whereas China’s neighbours underwent comprehensive financial sector globalisation during the 1980s and 1990s, China continues to retain many capital controls. While other transition economies adopted a “big bang” approach to financial sector globalisation, China has adopted a more gradual approach. It is this different approach, and China’s exceptional relative growth performance, that has prompted the attention of researchers. The changes brought by WTO entry have further heightened interest in the topic of China’s financial sector globalisation.

This chapter first discussed the types of policies China has used with respect to the globalisation of its financial sector. Prior to WTO entry in 2001, controls over foreign banks and international capital flows were largely maintained. The most prominent exception was FDI inflows. The achievement of RMB convertibility for current account transactions in 1996 was a watershed and additionally had the unintended effect of weakening the effectiveness of controls designed to stop Chinese capital moving abroad. Since WTO entry, foreign banks have been able to gradually expand their business scope into the RMB deposits and loans market and foreign investors have gained some access to China’s A-share market. There has also been increased institutional cooperation with foreign financial institutions taking equity stakes in Chinese banks and helping them sell off non-performing assets. Furthermore, China’s prudential authorities have based their latest regulatory framework on the international norm of the Basel Accord. Financial sector globalisation in China has also had a distinct geographical element, with liberalisation first being undertaken in coastal cities before later spreading to the central and western regions.

China's policies with respect to global financial integration have had several consequences. These have included reducing the reliance on foreign capital, skewing foreign capital inflows toward the form of FDI and directing the bulk of foreign capital inflows to the coastal regions. This experience offers a number of lessons for other countries. China's rapid growth and relative stability compared with other developing and transitional economies suggests that maintaining some capital controls can form part of an optimal policy framework in a second-best sense. Capital controls that have led to the bulk of foreign capital inflows being in the form of FDI have been particularly effective in contributing to stability. On the other hand, China's experience with capital flight and instances of capital control avoidance more generally, highlights that capital controls alone cannot segment a domestic financial system from international capital flows. Capital controls simply add to the transaction costs associated with such flows. Thus, citing the existence of capital controls as the primary reason China performed relatively well during the Asian financial crisis is dubious. Other large countries would also do well to note that policies that phase in liberalisation on a geographical basis could worsen the potential of the globalisation process to contribute to regional income inequalities. In conclusion, China's experience to date has already provided researchers with a rich case study of the process of financial sector globalisation and its interplay with policy choices. As the impact of WTO accession becomes clearer in the future, the lessons China offers for other countries undertaking financial sector globalisation will only grow.

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Table 1. Timetable of China's WTO banking sector commitments

	WTO entry plus (years)					
	0	**1**	**2**	**3**	**4**	**5**
Relaxation of geographical restrictions	Shanghai Shenzhen Tianjin Dalian	Guangzhou Qingdao Nanjing Wuhan	Jinan Fuzhou Chengdu Chongqing	Kunming Zhuhai Beijing Xiamen	Shantou Ningbo Shenyang Xian	No geographical restrictions
Relaxation of client coverage restrictions	On accession no limitation on foreign currency business	Local currency business to Chinese enterprises only				No client restrictions
Relaxation of company licensing restrictions	Total assets more than USD10 billion to establish subsidiary or joint venture. Total assets more than USD20 billion to establish a branch Further licensing requirements to engage in local currency business are 3 years business operations in China, being profit making for 2 consecutive years prior to the application.					No establishment restrictions
Activities allowed without exception	Auto financing by non-bank financial institutions Provision and transfer of financial information / software Advisory, intermediary services including credit reference and analysis, investment mergers and acquisitions and portfolio research.					

Source: Bonin and Huang (2002).

Table 2. Exchange rates[1] and capital flows[2] during the Asian financial crisis

	1996	1997	1998	1999
China				
Exchange rate	8.3	8.3	8.3	8.3
Net flows on short-term debt	0.4	0.7	-1.5	-0.2
Net Foreign direct investment	5.3	5.1	4.7	3.9
Thailand				
Exchange rate	25.3	31.4	41.6	37.8
Net flows on short-term debt	2.0	-7.2	-7.3	-5.3
Net Foreign direct investment	1.3	2.8	6.5	5.2
Malaysia				
Exchange rate	2.5	2.8	3.9	3.8
Net flows on short-term debt	6.6	4.1	-9.5	-3.3
Net Foreign direct investment	5.3	5.4	3.2	5.3
Indonesia				
Exchange rate	2342.3	2909.4	10013.6	7855.2
Net flows on short-term debt	2.8	0.3	-10.8	-1.2
Net Foreign direct investment	2.8	2.2	-0.4	-2.1
Korea				
Exchange rate	804.5	951.3	1401.4	1188.8
Net flows on short-term debt	3.9	-2.7	-0.5	1.6
Net Foreign direct investment	0.5	0.6	1.7	2.3

Notes:
1. Units of domestic currency / USD. Figures listed are period averages. The source is IMF (2004).
2. Capital flow figures are expressed as a percentage of gross national income. Short-term debt is defined as debt that has a maturity of one year or less. The source is World Bank (2003).