Investment Banking and Investment Opportunities in China

A Comprehensive Guide for Finance Professionals

K. THOMAS LIAW

John Wiley & Sons, Inc.

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To my family

Contents

Preface

This book is about China. It is written for market professionals and students who seek knowledge of China, which has become a magnet for business interests worldwide. Market professionals have great expectations in profiting from China's low manufacturing costs, huge consumer base, and opportunities in financial services. Students have interests in China for academic research and career opportunities. China's growing domestic demand and fast-rising foreign exchange reserves are having major impacts on international commodities prices and interest rates. China's foreign exchange policy is the center of attention of global financial markets. The 1.3 billion populations and the burgeoning economic growth result in exploding domestic markets. Financial services present profitable opportunities for foreign players to expand as well. The objective of this book is thus to provide a comprehensive analysis for the practicing professionals to advance professional development and for students interested in a career relating to China to gain relevant knowledge.

The book focuses on investment banking and investment opportunities in China. The book is dividend into three parts: Part I—Chapter 1 through Chapter 6—review China's financial markets and business environment. The coverage includes the economy, the financial markets, the WTO membership, opportunities and challenges of China investing, regulatory issues, and ways to invest in China.

Part II—Chapter 7 through Chapter 13—focus on investment banking in China. Large investment banks want to have a presence in China because privatization and market reforms present businesses in underwriting, advisory services, trading, derivatives, asset management, private equity, and restructuring. Goldman Sachs, Morgan Stanley, and several other institutions have invested in and established alliances with domestic firms. In addition, commercial banking and insurance presents great potentials. Many money center banks have taken strategic stakes in China's banks and insurance companies. Citigroup, Bank of America, and HSBC, for example, have invested billions and gained access to the burgeoning domestic financial markets.

Part III—Chapter 14 through Chapter 19—examine investment opportunities and the various means investors can use to profit from China's growth without venturing into China. Chapters in this part describe investment opportunities, growth investing, and value investing in China. This part also discusses financial instruments that foreign investors can use to invest in China's growth. Those include American depositary receipts (ADRs), Chinese country funds, and Chinese exchange-traded funds (ETFs).

In summary, this book is designed for use as a professional reference and an academic text suitable for business professionals and students interested in China's financial markets. For practitioners and investors, it demonstrates opportunities in China's economic growth and financial markets. The objective is to provide professionals with relevant and in-depth information in order to profit from doing business with China. For students, the text describes the full range of investment banking and investment opportunities in China. Such knowledge is helpful in today's global capital marketplace.

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Writing this book has been an enjoyable journey. I have traveled to Beijing, Shanghai, Hangzhou, Chongqing, Hong Kong, and Taipei many times. I have also attended and presented at conferences about China and business in Asia at Harvard University and at annual meetings of academic associations. During those conferences, I have had the opportunities to discuss a wide range of issues relating to China's economy and financial markets with many business executives, government officials, and academic scholars. Over the past several years, I have also benefited from discussions with and comments by a number of other individuals. They all contributed greatly to the book. I would also like to thank my editor, Richard Narramore, for valuable suggestions in structuring the book coverage. In addition, I thank Tiffany Groglio and the Wiley editorial team involved in the project.

I

Introduction to China's Financial Markets and Business Basics

1

An Overview of China's Powerful and Growing Economy

China is a magnet for business interests worldwide. It is one of the largest trading nations with annual imports and exports exceeding $1 trillion. It is the world's largest producer of many product categories. China's fast-rising foreign exchange reserves are having major impacts on international commodities prices and interest rates. China's foreign exchange policy is the center of attention for the global financial markets. The 1.3 billion population and the burgeoning economic growth have resulted in exploding domestic markets. Economic reforms, inflow of foreign direct investment, and membership in the World Trade Organization (WTO) are all major contributors to China's growth. In addition, China plans to gradually sell shares of stock of more than 1,300 largely state-owned companies to further the country's transition toward capitalism. This chapter provides an overview of China's economy, international trade, foreign exchange reserves, special economic zones, and effects of the accession into the WTO.

THE GLOBAL POWERHOUSE

From the initiation of the economic reforms in 1979 through 2006, China's gross domestic product (GDP) grew at an average rate of more than 9 percent. Many economists speculate that if China sustains this level of growth, it could become the world's largest economy by 2050. International trade has been a major part of China's booming economy. The large monetary flows of foreign direct investment and foreign-invested firms accounts for a significant portion of China's trade. The resulting surge in foreign exchange reserves has given rise to debates on China's currency policy and how the policy affects its economy and that of its trading partners.

China's Economic Development

Before the initiation of the economic reforms starting in 1979, China was an isolated, centrally planned economy. The economy was made up of predominantly Beijing-controlled, state-owned enterprises. Foreign-invested firms or private enterprises were virtually nonexistent. The Communist philosophy was "take what you need" not "what you deserve." There were no incentives to work hard. The economy was inefficient and stagnant.

Starting in 1979, China launched several economic reforms. The government permitted (and thus encouraged) price and ownership incentives for farmers by allowing them to sell a portion of their crops in the free market. Beijing also sought to decentralize economic policy making in several economic sectors. In addition, the government established special economic zones and development zones that offered tax and trade incentives to attract foreign investment (discussed in detail in a later section). The economy grew faster, from 5.3 percent pre-reform (1960–1978) to more than 9 percent post-reform (1979–2006).

The economic output of $2.26 trillion in 2005 sent China past France, Britain, and Italy to become the fourth largest economy in the world.[1] China's rapid growth and trade expansion could be sustained into the future, provided China is able to keep the economic reforms going, prevent the economy from over heating, and develop the tens of thousands of new managers crucial to continue the economic miracle.

China has emerged as an economic powerhouse with tremendous opportunities for all those who want to unleash this market's vast potential. Since 1980, China has grown faster for longer than any country in history. China now accounts for 13 percent of global outputs based on purchasing power parity (PPP) exchange rates. China's accession to the WTO and events like the awarding of the 2008 Olympics to Beijing attest to China's growing importance on the world economic stage. Key to China's economic growth is its entry into global markets, not only through foreign direct investment, but also through its impressive growth of exports and imports. Economic reforms also led to higher efficiency and enhanced productivity in the economy, boosting output and increasing resources for additional investments. Reform of the financial sector has moved up the policy agenda, especially after joining the WTO, to better support China's economic expansion.

This exceptional economic performance is leading to huge wealth creation. A growing number of Chinese people now have a net worth of more than $1 million. Chinese purchasing power now represents 12 percent of the global sales of luxury handbags, shoes, jewelry, and the like. Bentley Beijing is one of Rolls-Royce's top-selling dealerships. Shanghai hosted the Formula One Grand Prix in October 2005. Shanghai's Maglev, one of the world's fastest trains, began full operation in March 2004, covering the 20 miles from Shanghai to Pudong International Airport in a blistering 7 minutes and 20 seconds. With such economic power and rising visibility on the global stage, China attracts foreign investments of $60 billion a year. In addition, China's international trade (imports and exports) has exceeded $1 trillion per year since 2004 and its foreign exchange reserves crossed over the $1 trillion mark to $1.066 trillion at the end of 2006.

The 1.3 billion Chinese customers present tremendous market opportunities for all kinds of products and services. Multinationals use China not only as a manufacturing base to compete regionally or globally but also to compete in its burgeoning domestic market. The enormous workforce and the low wages give China huge cost advantages. Thus, China has been able to import materials and export products at very competitive terms. This results in trade surpluses year after year. The investment power of the foreign exchange reserves has significant impact on global interest rates. For example, the *Chicago Tribune* reported on January 14, 2006, that mortgage industry watchers were concerned about China's recent signal to diversify its foreign investments.[2] Market watchers were concerned that if China purchased fewer U.S. Treasury securities or agency securities (such as those issued by Freddie Mac and Fannie Mae), it might drive interest rates higher and substantially cool the real estate market.

Adding to those advantages are the high expectations of China that most people have. Such high expectations motivate investors and companies all over the world to allocate resources to China. Those investments are creating more opportunities, which in turn lead to higher expectations. To realize those expectations, investors and companies needed to have access to China. When China joined the WTO in 2001, it provided foreign institutions that access.

Profit from China's Burgeoning Growth

China's development has been a good thing for the West. Companies from all over the world buy, sell, and invest in China. They are profiting from China's competitive production costs, huge domestic markets, and direct investments in growing sectors.

Many domestic-focused companies in the West and Japan cannot compete with China in the production of computers, clothes, toys, and electronics. Thus, they established facilities in China to take advantage of low production costs. About half of the exports coming out of China are from big foreign multinationals that use the mainland as a production base. Multinationals hope to be able to compete with Chinese companies to sell their products and services in the Chinese domestic market.

The high-tech sector is highly penetrated by foreign firms. Many of the U.S. and European big names have established operations in China. For example, Motorola and Nokia see China as their biggest market. Microsoft, Yahoo, and Google are all big players. Automobile companies such as Volkswagen, General Motors, Toyota, Nissan, and Honda grab the majority of the market share. Although Volkswagen has represented the largest car sales for many years, other manufacturers are beginning to make inroads. For example, Cadillac plans to have 40 showrooms in China by year-end 2007.

In the rapidly growing banking and financial services markets, global financial institutions such as HSBC, Bank of America, Goldman Sachs, Morgan Stanley, Merrill Lynch, and Citigroup are expanding operations and buying stakes at large state-owned banks. Investments in other sectors, by way of venture capital or private equity, are booming as well.

Road Map to the Book

This book describes the super growth in China, presents what the opportunities are and how to profit from them, and discusses the potential risks. Part I introduces opportunities in China and business basics. We start by describing China's growing economy and financial markets. We then discuss the opportunities that come with the opening of China, how to position and profit from them, the business culture, and the risks. This part also covers business and financial regulations and how to enter the Chinese market.

Part II focuses on investment banking. Major activities include private equity, mergers and acquisitions, underwriting, derivatives, and asset management. Those operations are expected to bring in billions of dollars of income for financial companies from the United States, Europe, and Japan. Many large financial houses have already established a presence or formed strategic partnerships with Chinese institutions.

Large institutions can invest directly in China. Retail investors have other ways to get into the game as well. Part III describes the major vehicles investors use to "indirectly" invest in China by way of investing in Chinese stocks and funds traded outside China. Many Chinese companies list their shares in Hong Kong, London, and New York. Mutual fund companies have also established funds to specifically invest in China. Furthermore, exchange-traded funds representing the Chinese stock market or sector indexes provide foreign investors an efficient and liquid means to access the Chinese stock markets.

RAPIDLY EXPANDING INTERNATIONAL TRADE AND FOREIGN EXCHANGE RESERVES

Economic reforms have made China a major trading power. China's exports grew from $14 billion at the start of the economic reforms in 1979 to $762 billion in 2005 while imports increased from $16 billion to $660 billion. In 2005, the trade surplus was $102 billion. Much of the surplus came from exports to the United States and Europe. Excluding the United States, China actually had a deficit of $12 billion. As is clear from the Table 1.1, China's international trade surpassed $1 trillion in 2004 and continued to increase in subsequent years. China's foreign trade of $1.4 trillion in 2005 made it the third largest foreign trader behind the United States and Germany. If this pace of growth continues, it is likely to overtake the United States as the largest exporter by the end of the decade.

The expansion process has been facilitated by trade reforms and the general opening of the economy that have attracted surging foreign direct investment (see Table 1.2) and increased integration with the global trading system. Given China's size and substantial development potential, it will continue to have a large impact on the global economy. China's top-10 export destinations are the United States, Hong Kong, Japan, South Korea, Germany, the Netherlands, United Kingdom, Taiwan, Singapore, and Italy. Key import suppliers are mostly from Asia. The top import sup-

TABLE 1.1 China's International Trade

	Exports ($ Billions)	*Imports ($ Billions)*
1979	13.7	15.7
1980	18.1	19.5
1981	21.5	21.6
1982	21.9	18.9
1983	22.1	21.3
1984	24.8	26.0
1985	27.3	42.5
1986	31.4	43.2
1987	39.4	43.2
1988	47.6	55.3
1989	52.9	59.1
1990	62.9	53.9
1991	71.9	63.9
1992	85.5	81.8
1993	91.6	103.6
1994	120.8	115.6
1995	148.8	132.1
1996	151.1	138.8
1997	182.7	142.2
1998	183.8	140.2
1999	194.9	165.8
2000	249.2	225.1
2001	266.2	243.6
2002	325.6	295.2
2003	438.4	412.8
2004	593.4	561.4
2005	762.0	660.1
2006	961.1	791.7

Source: (1) International Monetary Fund, "Directions of Trade Statistics"; (2) *New York Times,* January 11, 2006; (3) News release, Embassy of the People's Republic of China in the United States, January 10, 2007.

pliers are Japan, South Korea, Taiwan, the United States, Germany, Malaysia, Singapore, Australia, Russia, and Thailand.

International Trade

China has emerged as a trade giant for imports and exports. On the export side, China has long claimed success as the world's factory for light industrial goods for export, such as textiles and toys, and continues to enjoy success in this area. At the same

TABLE 1.2 Foreign Direct Investments in China

	1990	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*
No. of Contracts	7,273	37,011	24,556	21,001	19,799	16,918	22,347	26,139	34,171	41,081	43,664	44,000
Amt. Contracted ($ Billion)	6.60	91.28	73.28	51.00	52.10	41.22	62.38	69.19	82.77	115.07	153.47	na
Amt. Utilized ($ Billion)	3.41	37.52	41.73	45.26	45.46	40.32	40.72	46.85	52.74	53.51	60.63	60.33
U.S. No. of Contracts	357	3,474	2,517	2,188	2,238	2,028	2,609	2,594	3,363	4,060	3,925	na
U.S. Amt. Contracted ($ Billion)	0.36	7.47	6.92	4.94	6.48	6.02	8.00	7.51	8.20	10.16	12.17	na
U.S. Amt. Utilized ($ Billion)	0.46	3.08	3.44	3.24	3.90	4.22	4.38	4.86	5.40	4.20	3.94	3.06
U.S. Share of Contracted Investment	5.40%	8.20%	9.44%	9.68%	12.44%	14.59%	12.83%	10.85%	9.91%	8.83%	7.93%	na

Source: The U.S.-China Business Council.

time, China has also focused on production of high value-added exports. This transformation is reflected in the significant shift in China's exports away from basic manufactured items and textiles into electronics and high-tech products, which now account for an increasing share of China's exports. For example, the customs figures showed that in 2005 China's high-tech exports rose 32 percent year-on-year to $218.3 billion. Exports of electronics products also rose 32 percent to $426.8 billion, accounting for 56 percent of total export value for the year. This move is further strengthened by the fact that Taiwanese manufacturers are making use of China's low-cost production as a base for high-tech manufacturing, more for re-importing into Taiwan than for China domestic sales. Table 1.3 lists China's market shares in Japan, the United States, and the European Union.

China has experienced a tremendous increase in infrastructure-related imports as it modernizes across the transportation, power, shipping, and telecom industries to foster the development of industry and sustain economic growth. Projects to develop infrastructure go hand-in-hand with China's efforts to support the surge in foreign direct investment. China has proven its ability to meet promised timeframes for order fulfillment and to satisfy the requirements of U.S. and European importers. High quality goods consistently delivered on time, along with access to markets and competitive pricing, have all contributed to China's success story. This success is reflected in an impressive real gross domestic product growth of 10 percent in the most recent three years, and a continued steady growth in trade, which reached $851 billion in 2003 and over $1 trillion in 2004.

As China broadens its production base to include higher-value products, the country's requirement for raw materials has grown in parallel with increased global demand. For example, oil demand is rising rapidly as the government works to diversify energy sources and move away from a reliance on coal. China accounts for about one third of the growth in global oil demand. There is also a rapid rise in demand for natural gas and hydropower. Companies in China, both multinational and state-owned enterprises (SOEs), need raw materials and semifinished goods for conversion to larger-ticket goods for sale in the domestic market and for re-export overseas. This, in turn, is driving an increased inflow of commodities.

TABLE 1.3 China's Export Market Shares (Percent)

	1970	*1980*	*1990*	*1995*	*2000*	*2003*	*2005*
Japan	1.4	3.1	5.1	10.7	14.5	18.5	11.03
United States	0.0	0.5	3.2	6.3	8.6	12.5	21.42
European Union	0.6	0.7	2.9	3.8	6.2	8.9	18.87

Source: International Monetary Fund, "Direction of Trade Statistics."

Note: Figures are imports from China divided by total imports, in percentage.

The immediate challenge is to keep up with China's voracious commodities appetite and the growing world demand for Chinese goods. These two demands are putting an upward pressure on pricing. For example, as the world's largest producer of steel, China requires a large inflow of iron ore and other ingredients for steel production. Commodity flows to China such as iron ore, copper, and oil have all seen price increases. With world pressure to keep the supply of raw materials apace with demand, the related challenge is to maintain competitive pricing for commodity imports. Upward pricing pressure must be kept in check to facilitate China's processing of raw materials to finished goods at competitive prices. This impacts China's ability to compete on big-ticket exports destined for large U.S. and European importers and importers in developing countries where China has made considerable inroads.

There has been a significant shift in share of total Asian exports into China. The fact that China has become increasingly prominent as an export destination for Asia as a whole underscores China's growing role as the Asian production hub. In addition, more intermediate products are being shipped to China for assembly before being shipped on to their ultimate markets. China's role in Asian regional trade has also become increasingly important. Imports from the region are growing rapidly, and China now is among the most important export destinations for other Asian countries (Table 1.4).

China's trade expansion in part reflects greater specialization in production within the Asian region. China now serves as the final processing and assembly platform for a large quantity of imports coming in from other Asian countries and then going out to the West. These changes have resulted in a shift in China's bilateral trade balances, with a significant portion of the surpluses with the West offset by the deficit with the neighboring countries, as evidenced by the trade statistics mentioned earlier that China ran a trade deficit with its trading partners excluding the United States. Reflecting this growing prominence and rising imports, China has been an important source of growth for the world economy. China's imports are growing rapidly from all trading partners and it is now the third largest importer of

TABLE 1.4 Imports to China (Percent)

	1980	*1990*	*1995*	*2000*	*2003*	*2005*
Asian	15.0	41.0	47.1	53.5	52.8	38.00
ASEAN	3.4	5.6	7.4	9.3	11.3	na
Japan	26.5	14.2	21.9	17.8	18.0	15.22
Korea	na	0.4	7.8	10.0	10.4	11.64
Taiwan	na	na	11.2	11.3	12.9	na
European Union	15.8	17.0	16.1	13.3	12.9	11.14
United States	19.6	12.2	12.2	9.6	8.2	7.42

Source: International Monetary Fund, Direction of Trade Statistics.

developing countries' exports after the United States and the European Union. It is the largest importer of copper and steel, and among the largest importer of other raw materials.

Foreign Exchange Reserves

China has accumulated more than $1 trillion in foreign exchange reserves. The allocation of those funds for investment purposes has huge implications on global financial asset prices and interest rates.

At the start of the economic reform in the late 1970s, China's foreign exchange reserves were minimal. In the early 1980s, export growth contributed to an initial increase in reserves that grew to $8.9 billion by 1983. Trade deficits in 1985 and 1986 eroded the reserves in those years (declined to $2.1 billion in 1986). In 1987, the surplus on trade in services slightly exceeded the merchandise trade deficit, producing a small current-account surplus, and a net capital inflow helped push reserves back up to $2.9 billion. The reserves were held above this level for another two years. The economic slowdown of 1989 to 1991 produced a sharp fall in imports in 1990, while exports continued to rise, producing a merchandise trade surplus for that year of $11.1 billion. The level of foreign exchange reserves crossed over the $100 billion mark in 1996 to $105.0 billion.

Joining the WTO in 2001 contributed to a rapid growth in China's imports and exports. Foreign direct investment inflows exceeded $50 billion a year in 2002 to 2003 and topped $60 billion a year in 2004 to 2006. Foreign exchange reserves reached a record $819 billion at the end of 2005 (see Table 1.5). By the end of 2006, the amount exceeded $1 trillion.

There has been much talk recently about stimulating private consumption in China, which is seen by a growing chorus of policy makers and analysts worldwide to be an important means of reducing China's growing external surplus. It is important for China to rebalance the economy away from heavy dependence on exports to lead growth toward self-sustaining domestic demand.

As companies have improved their performance, corporate savings have risen and now account for almost half of national savings. Corporations have an incentive to retain their earnings in order to finance their investment with internal funds. This is particularly true for private sector companies, which have limited access to bank financing and few domestic alternatives for raising money. State-owned enterprises that do make profits are generally not required to pay dividends to the government, and these companies naturally prefer to retain their earnings and plow them back into new investments.

By some measures, Chinese households have in recent years saved almost a third of their disposable income. One would expect a lower saving rate in an economy that still has a relatively low per capita income and, more importantly, good prospects for continued high income growth. So why do Chinese households save so much of their current income? Most observers believe the precautionary motive for saving is very strong among Chinese households because of the lack of an adequate pension system

TABLE 1.5 China's Foreign Exchange Reserves

Year	*$ Billions*
1977	1.0
1978	0.2
1979	0.8
1980	−1.3
1981	2.7
1982	7.0
1983	8.9
1984	8.2
1985	2.6
1986	2.1
1987	2.9
1988	3.4
1989	5.6
1990	11.1
1991	21.7
1992	19.4
1993	21.2
1994	51.6
1995	73.6
1996	105.0
1997	140.0
1998	145.0
1999	154.7
2000	165.6
2001	212.2
2002	286.4
2003	403.3
2004	609.9
2005	818.9
2006	1,066.0

Source: State Administration of Foreign Exchange, China.

and the sharply rising costs of health care. Demographic factors add to this saving motive. The one-child policy instituted in the 1970s to control population growth has led to a declining young working class to support the old generation. The need to finance education expenses has also bolstered saving.

The slow development of financial markets in China has meant limited availability of credit, so that households generally have to save in order to purchase big-ticket items, like houses and cars, rather than being able to borrow against future income. It also has meant that there are low returns on households' financial assets and limited opportunities for portfolio diversification, since there are few alternatives to depositing savings in state-owned banks.

All of this suggests that financial market reform and development is a key priority, which the Chinese authorities recognize. The pace of the reform has picked up since China joined the WTO in 2001. Enterprises might be less compelled to rely on internally generated funds if they have access to financial markets to raise capital. Increased access to credit for households, the availability of a wider range of saving instruments that would help them to diversify risk, and higher returns on their assets also could contribute to a reduction in household savings. Thus, building a broader-based, well-functioning financial market would help to rebalance China's economy by tilting domestic demand growth away from heavy reliance on investment toward consumption. Exchange-rate flexibility could have a role by providing more scope for monetary policy independence and helping cushion the economy from economic shocks. It could contribute to rebalancing the economy by improving investment decisions, and the appreciation of its currency raises consumption by bolstering households' real incomes. The government also has a major part to play in influencing saving and consumption, particularly through provision of education, health care, and pensions. Reducing uncertainties in these areas could substantially diminish the strong precautionary saving motive among Chinese households and give them the confidence to raise their consumption.

SPECIAL ECONOMIC ZONES

China's special economic zones (SEZs) are a unique approach to economic development. Chinese policy makers realized that international trade and commerce had the potential for improving China's overall economic situation. They also recognized that by inviting foreign investors into the country, they could learn about foreign technologies and business practices. The establishment of the SEZs allowed Beijing to try out unconventional market-oriented techniques to promote economic development in designated geographic areas. If the experiments were successful, they could be applied to other parts of the country. If the specific measures were not beneficial, the effect was minimized. This gradual approach has enabled the country to become more open and efficient while avoiding unwanted economic or social instability. As such, the objectives are to use innovative market techniques to develop the coastal areas, to attract foreign investment to modernize China's industries, and to serve as a window to the outside world. The establishment of the SEZs has unambiguously contributed to the super economy of China today.

The main SEZs are Shenzhen, Zhuhai, Shantou, Xiamen cities, and Hainan Province. The Hainan Province SEZ was established in 1988 although the other four zones were established in 1980. Jiang Zemin, former president, stated that "The development of SEZs is an important part of building socialism with Chinese characteristics" at a grand gathering in Guangdong Province in 2000 to mark the twentieth anniversary of the establishment of the Shenzhen SEZ.[3] However, SEZs open China to the world and are heavily influenced by capitalism. As a result, those zones probably will not contribute to "building socialism" but instead to transforming China into a capitalist market.

In addition to the five SEZs, the concept also includes open coastal cities, coastal economic open zones, high-tech industrial development zones, export-processing zones, bonded areas, and Shanghai Pudong New Area. Since 1984, China has opened coastal cities, including Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Pudong Area of Shanghai, Ningbo, Fuzhou, Guangzhou, Zhanjiang, Beihai, and others. Connected by railways with inland, the open coastal cities serve as important trade ports. From 1984 to 2002, the State Council ratified 49 economic and technological development zones (including Dalian, Tianjin, Ningbo, Beijing, and Harbin) to attract foreign investment and speed up economic development. Likewise, coastal economic zones act as the bridge and window for foreign trade and the base for earning foreign exchange through exports. Furthermore, high-tech industrial development zones promote the development of science and technology that are key to international competition. The State Council has approved 53 state-level high-tech development zones. Another related area is export-processing zones. Those aim at more efficient processing and management of trade. The bonded area in Pudong New Area was established to promote the development of export-oriented services. In addition, the Shanghai Pudong New Area aims to develop Pudong as an export-oriented, multifunctional, and modern area for pushing China's economy into the future.

Development of the Special Economic Zones

The SEZs were initially established after the model of export-processing zones in Taiwan and Korea.[4] The first Asian export-processing zone was in Kaoshiung, Taiwan, as a key strategy for outward industrialization policy that was the foundation of Taiwan's economic achievement. The role of SEZs in China's development is similar to that of export-processing zones in high-performing East Asian countries. However, China's industrial development may not follow a pattern similar to the East Asian model because of China's socialism, its vast size of land, and enormous regional diversity.

Before the establishment of the SEZs in Guangdong Province, a small area in Shekou was marked out in Shenzhen as an export-processing zone. The SEZs were originally intended to serve as a place for testing new reforms of enterprise management, finance, and labor matters. This was a significant development because Beijing sought, for the first time, to link foreign investment with trade in those zones. By providing preferential treatment and facilities for foreign investment and trade, the SEZs turned the inward-looking strategy to an open-door policy. The five SEZs together with 14 other coastal cities constituted the front line of the open-door policy. The locations of four of the SEZs were selected because of their proximity to Hong Kong and Taiwan with easy access to information, technology, management know-how, and capital. In addition to economic factors, political considerations were also involved in selecting SEZs in Guangdong and Fujian Provinces. Selecting SEZs far away from the major centers of population confined the possible disruptions of the SEZs within the existing order.

Consequently, in August 1980, the People's Congress passed Regulations for the Special Economy Zone of Guangdong Province. The word "Special" refers to the special policies and flexible measures granted by the central government, allowing SEZs to utilize a special economic management system to:

- Experiment with and acquire of modern high-tech and management expertise
- Create employment
- Earn foreign exchange reserves through promotion of exports
- Promote economic development and regional development
- Create links with Hong Kong, Macao, Taiwan, and overseas Chinese communities
- Experiment with new economic reform with market forces

World Trade Organization Impact

The SEZs showed a great degree of flexibility in attracting businesses and allowing different types of arrangements for foreign investors. The zones provided investors with specific benefits that were not available elsewhere in the country. Those incentives along with infrastructure improvements and a legal and administrative system favoring the establishment of private and joint-venture enterprises led to a flood of foreign investments.

China's membership in the WTO presents challenges. With WTO membership, Beijing is trying to unify income tax rates for domestic and foreign corporations. Foreign enterprises enjoyed a 15 percent income tax rate versus the standard 33 percent national rate. Tax holidays of two or three years were common in the 1980s and 1990s. With the new policy, this dual tax scheme may no longer exist. How does the dismantling of these preferential treatments affect China's SEZs? Some argue that the loss of various incentives will cause foreign companies to locate in other parts of the country or in other parts of Asia. Others believe that membership in the WTO will not be the end of the SEZs but will require Beijing to reposition its policies to attract foreign investors.

MEMBERSHIP IN THE WORLD TRADE ORGANIZATION

China joined the WTO on December 11, 2001, as part of an ongoing process of integration into the global economy that started with the open door policies in the late 1970s. Membership in the WTO signified another stage of China's economic restructuring. It is also a political statement that the economic reforms and open-door strategies will continue. Membership indicates a broadening of international trade reform from a policy that had been focused on SEZs to a more comprehensive approach under which China agreed to change its laws, institutions, and policies so that they conform to the norms of international trade.

Process Leading to Membership

China applied to become a member of the General Agreement on Tariff and Trade (GATT) on July 11, 1986. From 1986 to 1989, GATT conducted meetings to settle problems with regard to China's application. During this period, GATT's contracting parties, including Japan, the European Community (EC), Australia, New Zealand, and Canada supported China's accession. The process was going smoothly without China agreeing to any major changes in its trade policy to meet GATT requirements.

However, all the goodwill GATT members showed toward China was lost after the Tiananmen Square incident on June 4, 1989. China's suppression of the democratic movement derailed the accession process, and most contracting parties withdrew their support. The United States made greater demands for economic reform as a condition for China's membership. As a result, China began to align its policy with GATT requirements.

By 1991, China's relationship with the United States had soured over disputes on China's handling of intellectual property rights (IPR), China's most-favored-nation (MFN) status in the United States, human rights violations on the mainland, and Beijing's military technology transfers to third-world countries. These issues created difficulties for China as it sought renewal of its MFN status by the United States. As a result, China changed its tactics and started to negotiate with smaller countries. China won the support of Belgium, Brazil, and Argentina, and soon had won over other, more important, contracting parties, such as Germany, Australia, and Great Britain. Bolstered by this new momentum of support, China was able to gain the support of still other countries.

The period from 1989 to 1992 marked two important themes: building a coalition of support outside the United States and internal policy changes to conform to GATT principles. During this period, China offered several significant concessions, including: (1) amendment of Sino-foreign investment law in December 1989, (2) publication of trade policies in December 1991, and (3) the establishment of a research institute to study international trade rules and to help the country rejoin GATT.

As GATT evolved into the WTO, China had the opportunity to gain a founding member status. Yet, China's contentious relationship and trade imbalance with the United States continued to hamper its quest for membership. After more than a year and a half of inactivity on China's part, it resumed negotiations with GATT in February 1992. Negotiations continued until December 1994 because both United States and other member countries demanded concessions from China in many areas. The primary focus of negotiations during 1992 to 1993 was on tariff reduction. In 1994, the emphasis shifted to other areas, such as intellectual property rights and market access by service sectors. China's desire to become a founding member led to many concessions on its part including: (1) concessions on human rights issues, (2) concessions covering sensitive areas, such as the automobile industry, and (3) extension of copyright protection.

With many major concessions addressed, the EU, Japan, and Australia supported China's admission into the GATT by the first half of 1994. To win the support of the United States, China offered concessions on a list of products that no longer needed import licensing and named 50 import categories whose tariffs were to be reduced.

After its bid for founding member status failed, China suspended formal negotiations. Both the United States and China came to loggerheads as neither was ready to back down from its position. The United States was upset over China's lack of action on U.S. copyright infringement issues and the growing trade deficit with China. The beginning of 1995 was the breaking point, when talks on copyright issues fell through, a trade war broke out between the countries.

Other areas of dispute soon erupted, including China's aggression toward Taiwan and continued disputes over developing country status, which drew opposition from the U.S. commercial and agricultural sectors. With regard to developing country status, the United States considered China to be a developed country due to its vast economic size and fast economic growth. Yet, China viewed this designation negatively and believed it would result in economic instability. Formal bilateral negotiations were stalled. The EU attempted to restart negotiations on China's behalf; it recognized China's developing country status and pushed for a transition period that would gradually change China's status to a full member. This approach received a lukewarm reception from the United States.

In 1996, the WTO's larger contracting parties, such as the EU, Canada, and Japan, resumed formal negotiations with China and sought to accelerate China's accession. The EU "transition period" approach for China received widespread support among WTO members and China. The EU now focused its negotiations on addressing which areas would be phased in, how long would the phases last, and which areas were to be immediately opened. The EU sought better terms on market access, subsidies, and tariffs. Access to the automobile sector was the most significant issue because the EU demanded drastic cuts in Chinese automobile tariffs and greater transparency of China's long-term policies in the automobile industry. During 1996, the relations between the United States and China soured even further as a result of the intellectual property rights disputes. In March, the United States called for $3 million dollars in preliminary sanctions against Chinese exports due to China's failure to protect U.S. intellectual property rights. In June, China and the United States reached an agreement over intellectual property rights. Yet, other areas of American concerns needed to be addressed, such as agricultural issues and the trade deficit. This led the United States to push for increased access to China's markets.

In 1997, China made a series of offers to WTO members and carried out many negotiations with member countries. The new offers covered tariff reduction in which China reduced the average tariff rate from 23 percent to 17 percent by October 1997. Regulations on distribution and production for foreign companies in China also were addressed. China promised to open the wholesale and retail sectors to foreign investment and to grant rights to all enterprises in China to import or export after a short transition period.

During 1997, the U.S. Congress took a tough stance on a variety of issues with China and proposed several stringent sanctions, including: (1) a ban on prison-labor products, (2) a ban on travel to the United States by Chinese officials who engaged in religious persecution or who forced women to have abortions as a means of population control, (3) inclusion of American human rights monitors in Beijing, (4) a ban on American trade with companies controlled by the Chinese military, and (5) denial of below-market-rate international loans to China.

In 1998, negotiations centered on China's liberalization of the agricultural and services sectors. Adding to WTO members' arguments was the fact that China had increased its share of exports over its Asian neighbors as a result of the 1997 Asian financial crisis. Members maintained that China's increased fortunes allowed it to increase its share of Western countries' imports drastically. As a result, China offered to reduce tariffs to 10.8 percent by 2005 and to eliminate import restrictions on 385 types of commodities over the next 10 years. Additionally, China provided concessions concerning the telecommunications and services sectors, including banking and insurance markets.

In 1999, China focused its attention on negotiations with the United States. China offered tariff cuts on beef and wheat. The United States had several additional concerns, including accusations that the Chinese were stealing nuclear secrets from the United States, a rising trade deficit with China, and apprehensions raised by both U.S. steel and information technology industries.

To further complicate issues, a NATO bomb hit China's embassy in Belgrade during the conflict in Bosnia. To curb internal dissent over the incident, China suspended negotiations with the United States. As this issue faded, China resumed negotiations with the United States. By November 1999, the United States and China were in accord and reached a bilateral agreement. In the same month, another bilateral agreement was signed by China and Canada.

In January 2000, China and the EU held bilateral talks on several outstanding issues covering market access, tariffs, investment, and industrial goods. Other unresolved issues included market access for telecom and insurance companies. In February, China and India signed a bilateral agreement, which increased the trade volume between both countries. By May, China had agreed to concessions pushed by the EU, which resulted in the signing of a bilateral agreement. China made a commitment to lift restrictions on insurance business, which would include allowing foreign operators to sell the same products as their Chinese competitors. Restrictions on location of foreign insurers were relaxed—previously foreign insurers were permitted only in the cities of Shanghai and Guangzhou. Also, foreign partners in Chinese life insurance joint ventures would be permitted to exercise effective management control, for they could choose their Chinese partners and secure a legal guarantee of freedom from any regulatory interference in private contracts on a fifty-fifty equity basis. Additionally, in May 2000, China signed a bilateral agreement with Australia, after reaching an agreement to liberalize access to 1,000 product categories across agricultural and manufacturing exports and to key service sectors.

In September 2000, China and Switzerland reached a bilateral agreement. This left only Mexican-Chinese negotiations as the last remaining obstacle before the WTO accepted China as a member. In September 2001, China and Mexico wrapped up bilateral negotiations. China made concessions to extend its current countervailing duties on 1,300 Chinese products in textiles, garments, footwear, and toys for six years. It also permitted an antidumping measure, which allowed Mexico to maintain the import duties after a six-year period if it discovered dumping. The eighteenth meeting of the WTO China working group finalized legal documents on China's accession; China was formally approved as a member at WTO's November Doha meeting.[5]

Regulatory Changes

China made a variety of commitments to the WTO for membership. A summary of the eight subject areas follows:[6]

1. *Trading rights and distribution services:* China agreed to grant full trade and distribution rights to foreign enterprises by the end of 2004 (with some exceptions, such as for certain agricultural products, minerals, and fuels).
2. *Import regulations:* Import regulations largely concern general and product specific import tariffs. In addition to a number of specific tariff reductions, Beijing agreed to reduce the average tariff imposed on industrial goods and agricultural products from 24.6 percent and 31 percent to 8.9 percent and 15 percent, respectively (with most cuts made by 2004 and all cuts completed by 2010).
3. *Export regulations:* China agreed to accept GATT Article XI, which generally prohibits export restrictions other than duties, taxes or other charges related to the cost of administering an export regime. Exceptions are made for certain sensitive products, such as those whose export could compromise national security.
4. *Internal policies affecting trade:* China agreed to abide by the core GATT 1994 principles of MFN nondiscrimination (known in the United States as normal trade relations) and national treatment, which requires that foreign firms operating in China would be treated no less favorably than Chinese firms for trade purposes, especially as such treatment relates to taxation, regulatory transparency, and price controls.
5. *Investment:* China agreed to eliminate local content and foreign-exchange balancing requirements from its laws, regulations, and other measures. Importantly, China also agreed that importation or investment approvals would not be conditioned on requirements such as technology transfer and export offsets.
6. *Agriculture:* China agreed to limit subsidies for agricultural production to 8.5 percent of the value of farm output and eliminate export subsidies on agricultural exports.

7. *Intellectual property rights:* China agreed to implement the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement immediately upon accession. The TRIPS agreement sets down minimum standards for most forms of intellectual property regulation—copyright and related rights, industrial designs, patents, trademarks, and trade secrets—within all member countries of the WTO.
8. *Services:* China agreed to open the banking system to full competition from foreign financial institutions by 2007. Beijing also agreed to permit various degrees of foreign ownership in joint ventures in insurance and telecommunications.

Status of China's World Trade Organization Commitments

China met four significant WTO commitments in 2005. These areas are advertising, banking, freight forwarding, and insurance. In advertising, it met the commitment by allowing wholly foreign-owned enterprises (WFOEs) in advertising services when the Regulation on Management of Foreign-Invested Advertising Companies took effect on December 10, 2005. With regard to banking, China met its commitment when the China Banking Regulatory Commission announced on December 5 that it would allow foreign banks to expand their local currency business into Ningbo, Zhejiang; and Shantou, Guangdong. China opened Shenyang, Liaoning; and Xi'an, Shaanxi, in December 2004. In fact, China went beyond its WTO commitments and opened five other cities—Changchun, Jilin; Harbin, Heilongjiang; Lanzhou, Gansu; Nanning, Guangxi; and Yinchuan, Ningxia—in December 2005. In the area of freight forwarding, China met its commitments by allowing WFOEs in freight-forwarding agency services and to apply national treatment to capitalization requirements for foreign-invested freight forwarders. Another fulfilled commitment is insurance. Foreign-invested insurers no longer need to cede to the China Reinsurance Corporation a portion of the lines of the primary risk for nonlife, personal accident, and health insurance. The China Insurance Regulatory Commission also lowered the minimum required total asset level for an insurance brokerage license from $300 million to $200 million. The lower asset requirement took effect on December 11, 2005.

In 2006, China's new commitments were:[7]

- *Architectural, engineering, and urban planning services:* China will allow WFOEs in architectural, engineering, and integrated engineering services. Urban planning WFOEs have been permitted since May 2003.
- *Banking:* China has to lift all geographic and customer restrictions on their local currency businesses on foreign-invested banks. Moreover, China is scheduled to eliminate any nonprudential measures that restrict the ownership, operation, and operational form of foreign-invested banks. The combined phase-in of these commitments should mark the full opening of China's banking sector to foreign companies. It will allow wholly foreign-owned banks to provide local currency services to any Chinese client in any city. Full implementation of these commitments is made particularly important by the likelihood of continuing

restrictions on foreign investment in domestic banks, which is capped at 25 percent for all foreign investors and less than 20 percent for any one foreign investor.

- *Distribution and retail:* China is scheduled to allow WFOEs and other foreign-invested wholesalers and commission agents to distribute chemical fertilizers, processed oil, and crude oil. Implementation of this commitment will remove the last remaining product prohibitions for foreign-invested distributors, except for restrictions on salt and tobacco, which are to remain under state control.
- *Retail:* WFOEs and other foreign-invested retailers with 30 or fewer outlets should be allowed to sell chemical fertilizers. Foreign majority-owned chain retailers with more than 30 outlets should be allowed to sell motor vehicles. Implementation of these commitments will mark the completion of WTO-mandated openings in China's retail sector, though China will retain the right to prohibit foreign-majority owned chain retail outlets with more than 30 stores from selling tobacco products, certain chemicals, some agriculture items, and specific processed oil products.
- *Insurance:* The last of China's WTO commitment in insurance requires it to allow wholly foreign-owned insurers to engage in reinsurance; international marine, aviation, and transport insurance; and brokerage for reinsurance and large-scale commercial risks, international marine, aviation, and transport insurance.
- *Telecom:* China is scheduled to lift all geographic restrictions on mobile voice and data telecom services for Sino-foreign joint ventures. Foreign-invested mobile voice and data telecom providers were restricted to operating in 17 cities, including Beijing, Chongqing, Guangzhou, and Shanghai. After the geographic restrictions are lifted, China will have fully implemented its WTO commitments in these services. China's WTO schedule does not require it to lift the 49 percent cap on foreign ownership in a mobile service provider. In domestic and international services, China is scheduled to expand the number of cities and regions in which Sino-foreign joint ventures may operate and raise the cap on foreign ownership. Foreign-invested fixed-line telecom providers could operate only in Beijing, Guangzhou, and Shanghai. China's 2006 WTO commitments allow these service providers to expand into many of China's most important business centers: Chongqing; Chengdu, Sichuan; Dalian and Shenyang, Liaoning; Fuzhou and Xiamen, Fujian; Hangzhou and Ningbo, Zhejiang; Nanjing, Jiangsu; Qingdao, Shandong; Shenzhen, Guangdong; Taiyuan, Shanxi; Wuhan, Hubei; and Xi'an, Shananxi. In addition, the cap on foreign ownership should rise from 25 percent to 35 percent and should rise again to 49 percent by the end of 2007.

BEIJING 2008 OLYMPICS

Several months before China gained WTO membership, the International Olympic Committee (IOC) named Beijing as the host city for the 2008 Olympic summer games (Table 1.6). Accession into the WTO gave China MFN status with all its trading partners. The prestige of the Olympics has provided the government an extraordinary opportunity to showcase Beijing and China. Immediately after winning the bid, the Beijing Organizing Committee for the Games of the Twenty-ninth Olympiad (BOCOG) released a $34 billion plan featuring new highways, new railways, urban regeneration, and environmental initiatives to become ready for hosting the games. The marketing slogan is "One World One Dream."

China plans to use the 2008 Olympics to focus on the urban development of Beijing. The massive improvements to infrastructure together with the enhanced image displayed on the world stage will lead to a long lasting economic lift. Beijing's $34 billion plan covers five areas that will, after the event, continue to serve a broad range of needs for the economic, social, and cultural life of Beijing. The five areas are specialized sports facilities, infrastructure, environmental initiatives, urban regeneration and cultural heritage, and tourism promotion and hotel development.

In its initial plan, the Beijing Olympics committee proposed 37 facility sites for the 2008 games. Among those sites, 15 are existing facilities with five requiring refurbishment and 22 new facilities. To improve infrastructure, Beijing has budgeted $11 billion for transportation addressing road systems, bus systems, urban rail, and airport. Along with an improved transportation system, China is also working on enhancing infrastructure for utilities and telecommunications, with an additional $5.4 billion budget. The Olympics has been an important stimulus to Beijing's actions to improve the environment in the city. Beijing has budgeted $8.6 billion to bring blue skies back to the city by 2008, promising cleaner air than Paris. Measures target reducing pollution, a new waste treatment system, water and sewage plants, and the 125-kilometer tree belt (the forested area surrounding the city). The tree belt is one component of the larger "Green Great Wall" to forestall desertification throughout China. The urban regeneration Beijing makes in preparation of the 2008 Olympics has significantly impacted the real estate market, residential as well as business.

TABLE 1.6 Olympics Hosting Cities

Year	*City*
1972	Munich
1976	Montreal
1980	Moscow
1984	Los Angeles
1988	Seoul
1992	Barcelona
1996	Atlanta
2000	Sydney
2004	Athens
2008	Beijing

Beijing will demolish several older, inner-city housing structures and build new ones. Beijing will also develop new areas of the city and expand the infrastructure to service this area. Furthermore, the BOCOG is calling the 2008 Olympics the People's Olympics to place its culture and heritage on display for the world. Hotels and tourism will certainly enjoy a sharp uptick during the extended period surrounding the Olympics.

CONCLUSION

China's economy grew 10 percent despite the serious setback by the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003. The economy continued to expand at 10 percent in the subsequent three years. We reviewed the important elements of the Chinese economy and the growing influence of its rising foreign exchange reserves. The open-door policies and the establishment of the special economic zones were the foundation for the economy's expansion. The 2008 Olympics has presented an opportunity for China to upgrade Beijing's environment for long-term benefits of the economy.

2

Opening Financial Markets through World Trade Organization Membership

China's accession to the World Trade Organization (WTO) in December 2001 has sped up its reform of the financial system. China has committed to eliminating barriers and opening the financial sector to foreign investment. As a result, foreign institutions rushed to invest and tap into China's booming growth. Foreign entry will not only put pressure on domestic firms, but also will boost the efficiency of domestic institutions. Privatization of state-owned institutions will be a significant part of the process. This chapter outlines China's commitments in the financial sector, including banking, securities, and insurance. The coverage includes the markets that foreign financial institutions have participated in, anticipated growth areas, and the projected revenues.

CHINA'S TRADE COMMITMENTS

Trade reforms and commitments are crucial in promoting China's integration into the global trading system. Tariff reductions and the dismantling of nontariff barriers are largely the continuation of the reform policies. Past tariff reforms also included import tariff exemptions, especially for processing trade and foreign investment. Under China's WTO commitments, tariffs dropped to an average of 9 percent by 2005. In contrast, the opening of the markets to foreigners in services and other trade-related areas is a milestone. Foreign participation in areas such as telecommunications, financial services, and insurance was virtually nonexistant or marginal. China has also taken measures to lift restrictions on trading and domestic distribution for most products. In addition, China made commitments on national treatment and nondiscrimination principles.

China General Commitments

"International economic cooperation has brought about this defining moment in the history of the multilateral trading system," said Mike Moore, WTO Director-General, at the conclusion of the meeting of the Working Party on China's Accession.[1] As a result of the negotiations, China agreed to undertake a series of important commitments to open and liberalize its economy and industries. As a result, China will offer a more predictable environment for trade and foreign investment in accordance with WTO rules. A WTO news release at the conclusion of negotiations stated that some of the commitments undertaken by China are the following:

- China will provide nondiscriminatory treatment to all WTO members. All foreign individuals and enterprises, including those not invested or registered in China, will be accorded treatment no less favorable than that accorded to enterprises in China with respect to the right to trade.
- China will eliminate dual pricing practices as well as differences in treatment accorded to goods produced for sale in China in comparison to those produced for export.
- China will not use price controls for purposes of affording protection to domestic industries or services providers.
- China will implement the WTO Agreement in an effective and uniform manner by revising its existing domestic laws and enacting new legislation fully in compliance with the WTO Agreement.
- Within three years of accession, all enterprises will have the right to import and export all goods and trade them throughout the customs territory with limited exceptions.
- China will not maintain or introduce any export subsidies on agricultural products.

Under the agreement, China reserves the right of exclusive state trading for certain products such as cereals, tobacco, fuels, and minerals, and maintains some restrictions on transportation and distribution of goods inside the country. Many of the restrictions that foreign companies were subject to would be gradually eliminated or considerably eased after a three-year phase-out period. In other areas, such as the protection of intellectual property rights, China promised to implement the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement in full from the date of accession. On the other hand, prohibitions, quantitative restrictions, or other measures maintained against imports from China in a manner inconsistent with the WTO Agreement would be phased out or otherwise dealt with according to the mutually agreed terms and timetables specified in an annex to the Protocol of Accession.

China's Commitments in Goods and Services

The agreement further spells out China's specific commitments in goods and services. In the goods area, China committed to gradually eliminate trade barriers and expand market access to goods from foreign countries. After implementing all the commitments, China's average bound tariff level will decrease to 15 percent for agricultural products. The range is from 0 to 65 percent, with the higher rates applied to cereals. For industrial goods, the average bound tariff level will go down to 8.9 percent with a range from 0 to 47 percent, with the highest rates applied to photographic film, automobiles, and related products. Some tariffs would be eliminated and others reduced mostly by 2004 but no later than 2010.

The two largest categories in goods are textiles and agricultural products. Upon accession, China became a party to the Agreement on Textiles and Clothing and is subject to its rights and obligations. As for all WTO members, quotas on textiles ended on December 31, 2004, but there will be a safeguard mechanism in place until the end of 2008 permitting WTO member governments to take action to curb imports in case of market disruptions caused by Chinese exports of textile products. For agricultural products, China agreed to limit its subsidies for agricultural production to 8.5 percent of the value of farm output.

Three primary categories in services are telecoms, banking, and insurance. Since China's accession, foreign services suppliers have been permitted to establish joint-venture enterprises and provide services in several cities. Foreign investment in the joint venture was initially limited to a maximum of 25 percent. Within one year of accession, the areas were expanded to include services in other cities and foreign investment should be no more than 35 percent. Within three years of accession, foreign investment should be no more than 49 percent. After five years of accession, there would be no geographic restrictions.

In banking, foreign financial institutions would be permitted to provide services in China without client restrictions for foreign currency business. For local currency business, within two years of accession, foreign financial institutions started to provide services to Chinese enterprises. Within five years of accession, foreign financial institutions were allowed to provide services to all Chinese clients.

In insurance, foreign nonlife insurers would be permitted to establish a branch or a joint venture with 51 percent foreign ownership. Within two years of accession, China allowed foreign nonlife insurers to establish a wholly-owned subsidiary. Upon accession, foreign life insurers were permitted 50 percent foreign ownership in a joint venture with the partner of their choice. For large-scale commercial risks, reinsurance and international marine, aviation, and transport insurance and reinsurance, upon accession, joint ventures with foreign equity of no more than 50 percent would be permitted; within three years of accession, foreign equity share would be increased to 51 percent; within five years of China's accession, wholly foreign-owned subsidiaries were permitted.

Benefits of China's Accession

China's accession to the WTO has been beneficial to China and its trading partners. China's membership means reduced distortion of trade as Chinese export subsidies are eliminated and the use of state trading to control imports is reduced. It will increase Chinese imports of bulk commodities that can be more efficiently grown or produced in other countries. As market forces play a greater role and as transparency in policy decisions increases, there will be greater predictability of China's import demand and export sales. In addition, as WTO accession leads to further economic growth and rising consumer incomes, Chinese consumption of high-value products will rise. Those benefits were best summarized by Long Yongtu, head of the Chinese delegation at the eighteenth session of the Working Party on China:[2]

> The outcome of China's accession to the WTO will be marked with the feature of a "win-win" and "all-win" for China as well as for the world. As for the rest of world, after China's accession, the great potential of China's market will be gradually translated into actual purchasing power, so as to provide a huge open market to all countries and regions in the world. This would be an important contribution to be made by China to the [sic] mankind. As for China, it will further improve the market economic system to be in line with the current international rules and the principles of the WTO. China will, in light of the WTO principle of market opening on reciprocal basis, strength[en] its economic and technological cooperation with all the WTO Members including developing members. China's economic reform towards market economy and its policy of further opening-up will greatly accelerate China's modernization drive and enhance its ability to participate into international economy.

COMMITMENTS IN FINANCIAL SERVICES

China's accession to the WTO promises unprecedented market access for foreign banks, securities firms, insurance companies, and other financial institutions. With among the highest savings rates in the world, Chinese citizens present huge untapped potential for a broad range of financial products and services. A 2005 poll conducted by Deloitte & Touche found that more than 40 percent of financial firms were already involved in the Chinese market in some form, and that almost 30 percent were exploring how to become involved.[3] Only 18 percent of institutions polled had no interest in entering the market. More than 70 percent of firms polled said they intend to enter either via a joint venture or by setting up a representative office or branch. The remaining banks were considering either a direct investment in a domestic Chinese institution or use of a Qualified Foreign Institutional Investor.

China has exceeded its commitments on market opening under the WTO. Beijing is eager to cooperate with Western banks that are considering the market, and to encourage strategic investments by them. Opportunities for big banks range from serving their existing corporate customers, many of which increasingly need support for their fast-growing operations in China, to bringing new products and levels of financial sophistication to China's emerging middle class. Further, by introducing Western practices, global banks have a chance to bring China's banking system into line with internationally accepted standards.

Banking

In the banking field, China committed to loosening domestic banking regulations with regard to foreign banking institutions. It ultimately hopes to strengthen its banking system by encouraging limited equity investment in domestic banks and educating its workforce in modern banking practices.[4]

China's commercial banking industry currently consists of four large state-owned commercial banks (SOCBs) that have enjoyed dominant market shares in loans and deposits. Exposure to poor-performing state-owned enterprises (SOEs) has led to high nonperforming loans (NPLs). China has established four asset management companies (AMCs) in 1999 to buy NPLs from commercial banks. The four state-run AMCs are China Orient AMC, Great Wall AMC, Huarong AMC, and Cinda AMC. As of late 2005, those four AMCs have acquired about $325 billion of NPLs from China's five largest commercial banks. They have disposed of about $90 billion, mostly to domestic investors and local governments buying back the debt of SOEs in their jurisdictions. Disposals to foreign buyers remain relatively insignificant.

China has made major commitments to reform its banking industry with respect to foreign banks. Over time, foreign banks gradually will be given permission to accept deposits and extend credit. The geographic coverage of foreign banking operations extend from Shanghai and Guangzhou to other cities in China. By the end of 2006, the geographical restrictions would be lifted.

Insurance

China's major concessions in the deregulation of its insurance industry include:

- *Geographic limitations:* China permitted foreign property and casualty insurers to insure large-scale risks nationwide immediately upon accession to WTO and pledged to eliminate all geographic limitations within three years.
- *Scope:* China agreed to expand the scope of activities for foreign insurers to include group, health, and pension lines of insurance, which represent about 85 percent of total premiums, phased in over five years.
- *Prudential criteria:* China consented to award licenses solely on the basis of prudential criteria, with no economic needs test or quantitative limits on the number of licenses issued.
- *Investment:* China agreed to allow 50 percent ownership for life insurance. Life insurers can choose their own joint venture partners. For nonlife, China pledged to allow branching or 51 percent ownership on accession, and to form wholly-owned subsidiaries within two years.
- *Effective management control:* This was negotiated for foreign insurers in life insurance joint ventures, through choice of partner, and a legal guarantee of freedom from any regulatory interference in private contracts on a fifty-fifty equity basis.

- *Licenses:* China made a commitment to immediately give seven new licenses to European insurers, in both the life and nonlife sectors. Further, two European Union (EU) firms would be permitted to establish operations in two new cities.
- *Property and casualty:* In this sector, the state-owned People's Insurance Co. of China (PICC) had some 80 percent of the market. Geographic restrictions on foreign insurers were lifted once China joined the WTO.
- *Life:* China demographics, shrinking state subsidies for social services (such as medical care), and rising incomes virtually guarantee huge market potential in life insurance and increasingly in pension and health insurance as well. Chinese firms, particularly state-owned China Life, dominate the market.

China's life insurers, like its banks, need foreign capital and expertise. Beijing's pragmatic approach to dealing with these needs has been to grant case-by-case approvals of foreign investment in Chinese life companies and new life insurance joint ventures.

Deregulation has granted life insurers a broader scope to offer flexible investment-type products in addition to the fixed-rate, savings-type products that have dominated the market. In this area, foreign firms have a competitive advantage. As Chinese financial-market deregulation continues, foreign investors can expect life insurance companies to begin providing active asset management, for example, for pension funds.

Securities

Making certain that its capital markets continue to facilitate a steady flow of private investment into reforming state and nonstate enterprises is among China's highest priorities. Upgrading the capabilities and professionalism of China's domestic securities industry is part of this process, as is nurturing an institutional investment industry.[5]

The domestic securities industry is consolidating. To survive in a more competitive and open marketplace, securities firms must expand their capital bases. Better companies will likely raise equity from private placements and, in some cases, through initial public offerings in the domestic market or by listing overseas.

Apart from developing listed mutual funds, China needs and wants to expand and professionalize its asset-management institutions. Institutional managers, now generally securities firms and trust companies, take money from institutional investors, principally state-owned enterprises and listed domestic companies. Qualified foreign financial institutions have been given opportunities to participate in this sector. Since what the Chinese want most is foreign business know-how and capital, foreign participation will be limited to joint-venture arrangements.

Implications for the Financial Industry

As China phases out its restrictions on foreign entities and sells off its state-owned enterprises, the influx of business and financial services to support these industries will grow.[6] WTO accession is a catalyst to push China's economic restructuring and movement toward its aim of establishing a socialist market economic structure.

Yet, some sectors are plagued by concerns about the potentially disastrous implications that the liberalization process could have on the Chinese banking system. China's domestic banks are burdened with huge NPLs, inadequate regulatory and credit-control systems, and insufficient capital on which to operate, resulting in very low profitability. Undoubtedly there will be major changes in this sector; either China's banks will push for joint ventures to increase their banking sophistication or weaker banks will be acquired or liquidated. Restrictions on banking that have limited competition in the industry have been lifted gradually. The market practice will have to move toward risk-based pricing.[7]

In the securities business, the continued development of the stock market will be difficult unless China takes steps to improve corporate governance, transparency, performance-based compensation, and a legal system that protects investor interests. Furthermore, the current practice of rationing initial public offerings must stop. Whether a company is able to go public should not be based on the company's political connections, but on future profitability.

It was anticipated that the change in the fixed-income market would be most dramatic after entry into WTO. As in most developing countries, China's focus has been on the stock market. The fixed-income market is underdeveloped. The size of the bond market is relatively insignificant, and the markets are very thin with poor liquidity. This has created two significant problems: (1) Corporations rely on the stock market and house banks for financing and (2) credit risk is not monitored by investors, which has contributed to the severity of the financial market crises in emerging markets. The entrance of foreign securities firms will introduce the fixed-income culture. The development of the fixed-income market is essential; it provides capital to corporations and it requires credit analysis. Rating agencies will assess the financial status of the instrument and/or the issuer.

The mutual fund business and insurance are changing as well. In the past, there were closed-end mutual funds only. The Chinese government allowed the establishment of open-end mutual funds in May 2001. Many well-known asset managers from the United States and other countries have applied for licenses to operate open-end mutual fund businesses. In insurance, both domestic (such as People's Insurance Company of China) and foreign insurers (such as AIG) will eventually offer life, health, property/casualty, and financial insurance.

In summary, in the financial industry, an improved foreign investment environment will facilitate the inflow of foreign capital, technology, and management expertise. Leaders in the financial industry will help to develop a depth of products for managing risk, raising capital, floating debt, and providing insurance. This is also key to the privatization of state-owned enterprises.

MARKET OPENING IN BANKING

To sustain the necessary growth to modernize the economy and create jobs for millions of workers entering the labor force each year, Beijing faces continuous pressure to improve economic performance. The financial system serves as the foundation for the real sector to achieve its potential. China will have to rely in large part on the banking sector to engage in commercial banking under the rule of market forces. Banks need to shift away from their traditional role as suppliers of credit to SOEs, and SOEs need to restructure to improve their operating efficiency and financial condition. The four state commercial banks account for the largest share of the banking market. Exposure to poor-performing SOEs has negatively impacted on bank performance. Thus, Chinese authorities have taken a number of steps to strengthen the banking sector so it will be able to support continued rapid rates of growth. Agreements with the WTO have aided in that reform process. Under the WTO requirements, China had to open the market to foreign banks by 2006. Consequently, HSBC Bank (China), Standard Chartered Bank (China), Citigroup Inc. (China), and Bank of East Asia (China) were given license in early 2007 to engage in all banking businesses, including RMB business on the mainland. This section reviews the current reform process, discusses foreign entry, and presents the areas of important opportunities for foreign banks.

Banking Market Reforms in 2005 and 2006

As the date (December 2006) for China to fully open its financial industry to the outside world moved closer, all Chinese commercial banks accelerated their reform. In 2005 and 2006, there was an unprecedented increase in reform of the banking industry.[8] To sustain the economic growth and integrate fully with the global economy, China could not afford to fail in its reform of the state-owned commercial banks. China Construction Bank has been successfully listed in Hong Kong. Listings of Bank of China and Industrial and Commercial Bank of China have been successfully completed as well. Also in reform are city commercial banks across the country and the joint-stock commercial banks. In addition, consideration is being made on including reform of the rural credit cooperatives into the entire financial system reform.

In the first three quarters of 2005, the gross assets of China's banking institutions increased from RMB 31.6 trillion to RMB 36.0 trillion, up 13.8 percent. During the same time period, their gross liabilities increased from RMB 30.3 trillion to RMB 34.5 trillion, up 13.6 percent. The total assets increased to RMB 43.9 trillion by year-end 2006. By the end of 2006, the total liabilities were RMB 41.7 trillion. In terms of NPLs, the total in 2006 was RMB 1.25 trillion.

After Beijing selected Bank of China and China Construction Bank to pilot shareholding restructuring reform in late 2003, the similar reform of Industrial and Commercial Bank of China (ICBC) kicked off in April 2005. By June 2005, ICBC had completed its financial reorganization. On October 27, 2005, China Construction Bank made a successful IPO in Hong Kong, issuing 26.49 billion H-shares globally at a price of HK$2.35.[9] According to the estimated figures for 2005, the price-net assets ratio was 1.96 times, and the price-earnings ratio was 13.9 multiples. The capital raised from the listing was about $8 billion. ICBC also floated its shares in 2006, raising $19 billion.

Corporate governance reform remained a main content in reform of the state-owned commercial banks, in which standardization of corporate governance, establishment of a sound independent director system, intensification of risk management, and reshuffle of business proceedings became the crucial issues. The ICBC, Bank of China, and China Construction Bank have established standardized corporate governance frames. They completed the drafting, voting, and reporting for approval of their articles of association, rules of procedures for the board of directors, board of supervisors, and general meeting of shareholders, rules of procedures for their boards' special committees, and operational mechanisms. The placement of committees under the board of directors of the three banks also was completed. In spite of the differences in names, the fields covered by the committees are basically similar, covering development strategy, audit, risk management, personnel and compensation, and related-party transactions.

There are still many challenges facing the development of China's state banks. In particular, there are some new challenges in development:

- After getting listed, the state banks face new requirements of supervision rules and information disclosure. Following supervision criteria of international financial markets, agendas of the banks have to be reformed to build standardized corporate governance and improve their information disclosure system.
- To sustain profitability, changes in market conditions will pose a challenge for the restructured banks to have their financial indicators reach the level of internationally advanced banks. It is a major strategic task of the state banks to improve their operating efficiency, and optimize business and income mix on the basis of intensifying capital, cost, and risk restraints.
- Enhancing risk management capacity will be a long-term challenge to the state banks. High growth will be a marked feature of China's financial market in the future. Effective management of the risks associated with such growth will be the key for China's state banks to improve their management capacity.

In 2006, China was to fully open up its financial sector in which a new era when the global banking industry competes in the same market would appear. As mentioned earlier, four foreign banks have been granted license to operate like a local bank. Some of the state-owned commercial banks have listed their shares outside China. The Chinese banking industry is now truly global. Under strong government policy backup, China's state-owned commercial banks will enter a fresh development stage.

Entry by Foreign Financial Institutions

The allure of the largest consumer market and the opening of the banking sector have created a mad rush by foreign banks to become shareholders in China's banks. In recent years, many have invested in strategic stakes in Chinese banks. As Table 2.1 shows, International Finance Corporation (IFC) and HSBC started to acquire stakes in Nanjing City Commercial Bank and Bank of Shanghai in 1999 and 2001. Citibank followed with a 4.62 percent investment in Shanghai Pudong Development in 2003.

TABLE 2.1 Foreign Investments in Chinese Banks (as of October 2005)

Chinese Bank	*Foreign Investor*	*Date*	*Shareholding (%)*
Bank of Beijing	ING Bank	March 2005	19.9
	IFC	March 2005	5.0
Bank of China	Royal Bank of Scotland	August 2005	5.0
	Merrill Lynch	August 2005	2.5
	Li Ka-shing Foundation	August 2005	2.5
	Temasek	August 2005	10.0
	UBS	September 2005	1.7
	Asia Development Bank	October 2005	0.3
Bank of Communications	HSBC	August 2004	19.9
Bank of Shanghai	HSBC	December 2001	8.0
	IFC	September 1999	5.0
	IFC	December 2001	2.0
Bohai Bank (Tianjian)	Standard Chartered Bank	September 2005	19.9
China Construction Bank	Bank of America	June 2005	9.0
	Temasek	June 2005	6.4
Hangzhou City Commercial Bank	Commonwealth Bank of Australia	April 2005	19.9
Huaxia Bank	Pangaea Capital Management	September 2005	6.9
	Deutsche Bank	October 2005	9.9
	Sal. Oppenheim	October 2005	4.1
ICBC	Goldman Sachs	August 2005	5.8
	Allianz	August 2005	3.2
	American Express	August 2005	0.8
Industrial Bank	Hang Seng	April 2004	15.98
Jinan City Commercial Bank	Commonwealth Bank of Australia	September 2004	11.0
Minsheng	Temasek	July 2004	4.55
	IFC	July 2004	1.08
Nanjing City Commercial Bank	IFC	November 2001	5.0
	BNP Paribas	October 2005	19.2
Shanghai Pudong Development	Citibank	January 2003	4.62
Shenzhen Development	Newbridge Capital	December 2004	17.89
	GE Commercial Finance	September 2005	7.0
Xian City Commercial Bank	Bank of Nova Scotia	September 2004	2.5
	IFC	September 2004	2.5

Source: PricewaterhouseCoopers. "NPL Asia." November 2005.

The majority of foreign investments in Chinese banks took place in 2004 and 2005, to position themselves to take advantage of the WTO 2006 market-opening schedule.

One of those pre-IPO investments in China's top-tier state-owned commercial banks has paid off handsomely for Bank of America and Temasek. China Construction Bank Corp. sold a total of 26.49 billion shares and raised $8.02 billion on October 20, 2005 (listed on the Hong Kong Stock Exchange). It was China's largest ever IPO and was the world's largest of the year. The offering was priced at HK$2.35 a share, or 30 cents, at the high end of the expected range due to strong demand. The retail tranche of the IPO was 42 times oversubscribed.

Two other big mainland banks have listed in Hong Kong. The Bank of China listed in early 2006 and the Industrial and Commercial Bank of China (ICBC) in October 2006. ICBC's IPO raised $19 billion, the largest IPO in history. ICBC's market capitalization is now second only to that of Citigroup.

Business Opportunities for Foreign Financial Institutions

Relaxation of entry, product, and market controls presents a unique and enticing banking opportunity. Foreign banks are expanding activities in China. They all know the risks of venturing into this market, but the biggest risks for many large institutions are non-engagement. In 2005, PricewaterhouseCoopers surveyed 35 foreign banks with regard to their strategic issues in China.[10] Among the 35 foreign institutions, HSBC topped the peer ranking in foreign exchange trading, treasury, corporate lending, trade finance, and retail banking. Citibank claimed the top spot in project financing, investment banking, asset management, and corporate finance. Standard Chartered ranked third in many categories. Table 2.2 lists the peer ranking.

The 35 participants in the survey commented on their experiences, important markets in the next three years, and the mode of expansion. Many banks made money in corporate banking, treasury, and trade finance. In terms of loan exposure, as Table 2.3 shows, at least 10 banks extended credit to manufacturing, electronics, energy and mining, chemicals, automotive, food and beverage, communications, and construction/real estate industries.

Most banks anticipated a growth rate of at least 30 percent in revenues in 2005 and 2008. Four banks projected a growth of at least 100 percent in 2008, one anticipated 150 percent, and another forecasted 300 percent. Other results pointed to the market development in the near term:

- Many have provided services in trade finance, foreign exchange, top-100 corporate lending and treasury, and small to medium-sized enterprise (SME)

TABLE 2.2 Peer Ranking of Foreign Financial Institutions in China

	First	*Second*	*Third*
Foreign Exchange Trading	HSBC	Citibank	Standard Chartered
Treasury	BSBC	Citibank	Standard Chartered
Corporate Lending	HSBC	Citibank	Standard Chartered
Project Financing	Citibank	HSBC	Standard Chartered
Investment Banking	Citibank	Goldman Sachs	Morgan Stanley
Asset Management	Citibank	HSBC	Deutsche Bank
Corporate Finance	Citibank	HSBC	Goldman Sachs
Mergers and Acquisitions	Morgan Stanley	HSBC	Citibank
Trade Finance	HSBC	Citibank	Standard Chartered
Retail Banking	HSBC	Citibank	Standard Chartered

TABLE 2.3 Loan Exposure by Foreign Banks

I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*	*IX*	*X*	*XI*	*XII*	*XIII*	*XIV*	*XV*	*XVI*	*Total*
10		50				30					10					100
20		5				70						5				100
	10	10	20		40	10					5				5	100
	10				80		10									100
					50				30						20	100
	40				40				5				5		10	100
	20	10	10	20	10	10	10				10					100
			10		10				80							100
										80		10	10			100
		10		10						80						100
			10		10					70			10			100
					20					70					10	100
		5		25			5			60					5	100
	10	10	10			10				50			10			100
5	2			5	3	15	20			45			5			100
					33		33			34						100
	10		30		20					30	10					100
	5	6			12	12			15	30					20	100

(continued)

TABLE 2.3 (Continued)

I	*II*	*III*	*IV*	*V*	*VI*	*VII*	*VIII*	*IX*	*X*	*XI*	*XII*	*XIII*	*XIV*	*XV*	*XVI*	*Total*
		5	10							25	10				50	100
		10		10		25	10			20	5	5	10	5		100
	10			60						20		5	5			100
		5			20	10	5			20		10	10	10	10	100
	20	15	10	5		20	5			15			10			100
				10	50		10			15	5	10				100
0	5	6	4	20	10	10	4	1		14		11	3	3	9	100
20							60			10			10			100
	3					1				6					90	100
	10	10	10		20	10	5			5	10	10	10			100
				40		10		10		5	15		15	5		100

Source: PricewaterhouseCoopers. "Foreign Banks in China," September 2005.

Note: I = Agriculture, II = Automotive, III = Chemicals, IV = Communications, V = Construction/Real Estate, VI = Electronics, VII = Energy & Mining, VIII = Food & Beverage, IX = Knowledge Based Industries, X = Machines, XI = Manufacturing, XII = Paper & Forest Products, XIII = Retailers, XIV = Trading, XV = Transportation, and XVI = Other.

lending. Other services include: funds management, high net worth individuals, retail deposits, residential mortgage, and credit card marketing.

- The focused markets in the next three years (2005–2008) are foreign exchange, trade finance, money market, top-100 corporate treasury and lending, and SME lending. The emerging areas that present opportunities are funds management, high net worth individuals, credit cards, securities trading, retail deposits, consumer loans, Internet banking, and retirement products.
- The lines of businesses that banks are active in at present and plan to be in 2008 cover Renminbi, derivatives, funds management, transaction and custodian services, wealth management, and credit cards. Table 2.4 lists the markets where they had presence in 2005 and those they plan to service in 2008.
- Most of the banks in the survey indicated they would change their business model over the next three years. Regulatory changes and changes in product offerings are the primary driving forces that will affect their business model. Other areas of consideration include increasing customer demand, increasing competition, parent banking strategy, and state of the economy.
- In terms of expansion, the most preferred option is organic growth, followed by partnership with a commercial bank, and then with a Big Four; the large

TABLE 2.4 Banking Markets in 2005 and 2008

Market	*2005*	*2008*
Trade finance	33	33
Corporate Banking	31	31
Treasury/Foreign Exchange/Money Market	24	28
Project Financing	21	23
Correspondent Banking	21	22
Corporate Finance	19	21
Investment Banking	16	20
SME Lending	12	12
Term Deposits	10	15
Funds Management	7	12
Mortgages	6	12
Internet Banking	6	11
Bonds	6	16
Transaction & Custody	5	10
Private Banking	3	11
Wealth Management	2	4
Life Insurance/Risk Products	2	6
Credit Cards	1	9
SME Venture Capital	1	2

Note: Number in the second column under "2005" indicates the number of banks that provided services in the business line in 2005 and that in the third column under "2008" indicates the number of banks planning to be active in that market in 2008.

four state-owned commercial banks, including Bank of China, China Construction Bank, ICBC, and Agricultural Bank of China. Among those that indicated if they pursued a joint venture, the critical issues were the ability to exercise management control, protect the interests of foreign investors, raise stakes in domestic financial institutions, leverage to joint venture investment, build in exit mechanisms, and integrate nonbank financial services.

MARKET OPENING IN SECURITIES

Many investment banks see tremendous opportunities in China. Investment banking houses such as Goldman Sachs, Morgan Stanley, Citigroup, and UBS have all positioned themselves to take advantage of the market potentials. Access to China's market became a reality after China joined the WTO. Foreign securities houses now are able to establish joint-venture operations, become special members of all exchanges, and engage in underwriting A shares. In addition, they can engage in underwriting and trading B and H shares as well as government and corporate debt securities. At the same time, privatization of state-owned enterprises means many Chinese companies seek listing in foreign markets. For example, China Life, China Telecom, Suntech, China Construction Bank, Bank of China, and ICBC have listed their shares overseas.

Almost all major U.S. investment banks have operations in Hong Kong. However, an office in Hong Kong does not mean business in mainland China. The Chinese economy is growing at a record rate and many bankers see great potential. Some economists predicted China to be the second largest economy in the world after the United States by 2030. Even those who view the potential with less certainty cannot ignore it. Therefore, a growing group of global investment houses is setting up investment banking operations in mainland China, including Citigroup, JPMorgan Chase, Merrill Lynch, Goldman Sachs, Morgan Stanley, Lehman Brothers, HSBC, BNP, Credit Suisse, and UBS.

With the exception of Morgan Stanley's joint venture (China International Capital Corporation, CICC), the Chinese government has only recently granted permission to foreign investment banking houses to set up operations in China. Morgan Stanley and China Construction Bank set up a joint venture back in 1995, the first of this kind in China. The establishment of CICC gave Morgan Stanley a jump on its rivals. For example, it arranged a $1 billion global bond issue by China's Ministry of Finance in 1996. CICC later advised on China Telecom's purchase of Hong Kong Telecommunications for $1.2 billion and acted as co-underwriter for China Telecom's $3.9 billion public offering.

Citigroup bought 4.62 percent of Shanghai Pudong Development Bank for $67 million in 2003 and has invested in other Chinese financial operations as well. Goldman Sachs has a joint venture in China called Goldman Sachs Gao Hua Securities. Goldman Sachs owns 33 percent and Beijing Gao Hua holds 67 percent of the joint venture that focuses on underwriting A shares and RMB-denominated corporate debt. In addition, it also offers financial consulting services.

Merrill Lynch also has a joint venture with a one-third stake. Merrill negotiated the deal for more than a year with Huaan Securities. The objective of the joint venture is to engage in the mainland China underwriting business. Merrill and Royal Bank of Scotland led a group of investors in August 2005 to acquire 10 percent of Bank of China for \$3.1 billion. Bank of America paid \$3 billion for 9 percent of China Construction Bank. Furthermore, Goldman Sachs and Allianz have invested in Industrial and Commercial Bank of China. Table 2.5 lists joint-venture securities firms.

TABLE 2.5 Joint-Venture Securities Firms

Securities Firms	Major Shareholders/Promoters
1 China International Capital Corporation, Ltd.	China Jianyin Investment Limited
	Morgan Stanley International, Inc.
	China National Investment & Guaranty Co., Ltd.
	The Government of Singapore Investment Corporation
	Mingly Corporation
2 BOC International, Ltd.	BOC International Holdings
	China National Petroleum Corporation
	State Development & Investment Corporation
	China General Technology (Group) Holdings Limited
	Yuxi Hongta Tobacco (Group) Co., Ltd.
	Shanghai State-Owned Assets Operation Co., Ltd.
3 EVERBRIGHT Securities Co., Ltd.	China Everbright Group
	China Everbright Limited
	Xiamen Xinshiji Group Import & Export Co., Ltd.
	Dongguan Lianjing Industry Investment Co., Ltd.
	Nanjing Xinding Investment and Development Co., Ltd.
4 China Euro Securities Co., Ltd.	CLSA Asia-Pacific Markets
	Xiangcai Securities Co. Ltd.
5 Shanghai Daiwa SMBC Securities Co., Ltd.	Daiwa Securities SMBC Co. Ltd.
	Shanghai Securities Co., Ltd.
6 Goldman Sachs Gao Hua Securities Co., Ltd.	Goldman Sachs
	Beijing Gao Hua Securities Co. Ltd.

Source: China Securities Regulatory Commission.

Investment management industry started in China in 1998 when the CSRC approved 10 fund management companies for the first time. Unlike the United States, where the number of open-end funds dominates that of closed-end funds, there were no open-end funds in China until 2001. The lure of the Chinese markets lies in the country's high savings rate and low mutual fund penetration. In addition, the rising pension liabilities will also drive the growth of the fund management industry.

U.S. fund managers have entered the Chinese markets. Merrill Lynch established a joint venture with Bank of China International (investment banking arm of Bank of China). It began to sell the first fund in late 2004, listed on the Shenzhen Exchange in the first quarter of 2005. Despite it being the second listed open-end fund, the fund raised \$130 million, less than half the amount hoped for. China Southern Fund Management launched the first listed open-end fund in August 2004, raising RMB 3.54 billion. The fund could generate interest simply because of its novelty. Investors can either trade listed open-end funds like regular stocks on an exchange, or redeem invested cash as with a regular mutual fund. American International Group, UBS, ING, Societe Generale, and Allianz have also established a presence to tap into the \$1.5 trillion savings market. Table 2.6 lists joint-venture asset management companies in China.

Foreign banks have become active in domestic stock markets by way of qualified foreign institutional investors (QFIIs). As of year-end 2006, 52 firms have established QFIIs (see Table 2.7). According to a 2005 report from Merrill Lynch, fees from the securities business in China are projected to reach \$12 billion in 2009. Morgan Stanley and Goldman Sachs could each book more than \$1 billion in annual revenues there. Citigroup is thought to be able to capture the most revenue in the long run due to its commercial and consumer banking and finance businesses. Table 2.8 lists 2005 revenues from securities business and the projected levels in 2009.

MARKET OPENING IN INSURANCE

Under the WTO accession agreement, China is committed to opening its insurance market.[11] The main commitments of the Chinese government in opening the insurance business are discussed next.

Form of the Businesses

Immediately after China's entry to the WTO, nonlife insurers from abroad were allowed to set up branches or joint ventures in China. Foreign firms gained the permission to hold as much as 51 percent of the stake in the joint ventures. Two years after the entry, nonlife insurance firms from abroad would be allowed to set up solely funded subfirms in China, that is, there will be no restriction on the form of enterprise establishment. Immediately after the entry, foreign life insurers would be

TABLE 2.6 Joint Venture Asset/Fund Management Companies

	Companies	*Major Shareholders/Promoters*
1	China Merchants Fund Co., Ltd	China Merchants Securities Co., Ltd. China Power Finance Co., Ltd. China Hua Neng Finance Co., Ltd. COSCO Finance Co., Ltd. ING Group
2	Fortune SGAM Fund Management Co., Ltd.	Fortune Trust & Investment Co., Ltd. SG Asset Management Co.
3	Guotai Junan Allianz Fund Management Co., Ltd.	Guotai Junan Securities Co., Ltd. Allianz AG.
4	Fortis Haitong Investment Management Co., Ltd.	Fortis Investment Management Haitong Securities Co., Ltd.
5	INVESCO Great Wall Fund Management Co., Ltd.	AMVESCAP Dalian Shide Group Co., Ltd. Great Wall Securities Co., Ltd. Kailuan Group Co., Ltd.
6	Fullgoal Fund Management Co., Ltd.	BMO Financial Group Haitong Securities Co., Ltd. Shenyin & Wanguo Securities Co., Ltd. Huata i Securities Co., Ltd. Shandong International Trust & Investment Company Fujian International Trust & Investment Company
7	ABN AMRO XIANGCAI Fund Management Co., Ltd.	ABN AMRO Xiangcai Securities Co., Ltd. Shandong Xinyuan Holding Co., Ltd.
8	Everbright Pramerica Fund Management Co., Ltd.	Pramerica Investment Management Everbright Securities Co., Ltd.
9	SYWG BNP PARIBAS Asset Management Co., Ltd.	BNP Paribas Asset Management Shenyin & Wanguo Securities Co., Ltd.
10	China International Fund Management Co., Ltd.	J.P. Morgan Asset Management (UK) Limited Shanghai International Trust and Investment Co., Ltd.
11	BOC International Investment Managers	Merrill Lynch Investment Managers BOC International (China) Limited BOC International Holdings Limited
12	Franklin Templeton Sealand Fund Management Co., Ltd.	Franklin Templeton Inventments Sealand Securities Co., Ltd.

(continued)

TABLE 2.6 (Continued)

	Companies	Major Shareholders/Promoters
13	AIG-Huatai Fund Management Co., Ltd.	AIG Global Investment Corp Huatai Securities Co., Ltd. Suzhou New District Hi-tech Industrial Co., Ltd. Guohua Energy Investment Corporation (China) Jiangsu Communications Holding Co.
14	UBS SDIC Fund Management Co., Ltd.	UBS State Development & Investment Corp.
15	Harvest Fund Management Co., Ltd.	Deutsche Assets Management China Credit Trust Co., Ltd. Lixin Investment Co., Ltd.
16	ICBC Credit Suisse Asset Management Co., Ltd	Credit Suisse First Boston Industrial and Commercial Bank of China China Ocean Shipping (Group) Co.
17	Bank of Communications Schroder Fund Management Co., Ltd.	Schroder Investment Management Limited Bank of Communications China International Marine Containers (Group) Ltd.
18	CITIC Prudential Fund Management Co., Ltd.	Prudential Group CITIC Trust & Investment Co., Ltd. China-Singapore Suzhou Industrial Park Venture Co., Ltd. Suzhou Gao Xin Zone Economy Development Group Omni-Company
19	CCB Principal Asset Management Co., Ltd.	Principal Financial Services, Inc. China Construction Bank China Huadian Corporation
20	HSBC Jintrust Fund Management Co., Ltd.	HSBC Investments (UK) Limited Shan Xi Trust & Investment Corporation Ltd.
21	First State CINDA Fund Management Co., Ltd.	Colonial First State Group Ltd. China CINDA Asset Management Corporation
22	LORD ABBETT CHINA Fund Management Co., Ltd.	Lord Abbett & Co., LLC Changjiang Securities Co., Ltd. Tsinghua Holdings Co., Ltd.
23	Lombarda China Fund Management Co., Ltd.	BLP GuoDu Securities Co., Ltd. Pingdingshan Coal Co., Ltd.
24	KBC-GOLDSTATE Fund Management Co., Ltd.	Goldstate Securities Co., Ltd. KBC Asset Management Group

Source: China Securities Regulatory Commission.

TABLE 2.7 Qualified Foreign Institutional Investors

1	UBS Limited
2	Nomura Securities Co., Ltd.
3	Citigroup Global Markets Limited
4	Morgan Stanley & Co. International Limited
5	Goldman Sachs & Co.
6	The Hongkong and Shanghai Banking Corporation Limited
7	Deutsche Bank Aktiengesellschaft
8	ING Bank N.V.
9	JP Morgan Chase Bank
10	Credit Suisse First Boston (Hong Kong) Limited
11	Nikko Asset Management Co., Ltd.
12	Standard Chartered Bank (Hong Kong) Limited
13	Hang Seng Bank Limited
14	Daiwa Securities SMBC Co., Ltd.
15	Merrill Lynch International
16	Lehman Brothers International (Europe)
17	Bill & Melinda Gates Foundation
18	INVESCO Asset Management Limited
19	ABN AMRO Bank N.V.
20	Societe Generale Asset Management S.A.
21	Templeton Asset Management Limited
22	Barclays Bank PLC
23	Dresdner Bank Aktiengesellschaft
24	Fortis Bank S.A./NV
25	BNP Paribas
26	Power Corporation of Canada
27	CALYON S.A.
28	Goldman Sachs Asset Management International
29	Government of Singapore Investment Corporation
30	Martin Currie Investment Management Ltd.
31	AIG Global Investment Corp.
32	Temasek Fullerton Alpha Pte Ltd.
33	JF Asset Management Limited
34	Dai-ichi Mutual Life Insurance Company
35	DBS Bank Ltd.
36	AMP Capital Investors Limited
37	The Bank of Nova Scotia
38	KBC Financial Products UK Limited
39	La Compagnie Financierr Edmond de Rothschild Banque
40	Yale University
41	Morgan Stanley Investment Management Inc.
42	Prudential Asset Management(Hong Kong) Limited
43	Stanford University
44	GE Asset Management Incorporated
45	United Overseas Bank Limited
46	Schroder investment Management Limited
47	HSBC Investments (Hong Kong) Limited
48	Shinko Securities Co., Ltd.
49	UBS Global Asset Management(Singapore) Ltd.
50	Sumitomo Mitsui Asset Management Company, Limited
51	Norges Bank
52	Pictet Asset Management Limited

Source: China Securities Regulatory Commission.

TABLE 2.8 Securities Business Revenues ($ Millions)

	2005	2009 (Projected)
Equity underwriting	700	1,300
Debt underwriting	100	800
M&As	200	600
Asset management	400	1,700
Brokerage	300	1,100
Sales and trading	2,200	6,300

Source: Merrill Lynch, April 2005.

allowed to set up joint ventures in China, and to hold up to 50 percent stake in the joint ventures. They could choose their partners independently. Investors of the joint ventures are allowed to make joint venture clauses independently within the scope committed. Immediately after China's WTO accession, the foreign stake in Sino-foreign joint venture insurance brokerage companies was limited to 50 percent, and the percentage was capped at 51 percent within three years after the accession. Five years after the WTO entry, foreign insurance brokerage companies would be permitted to set up solely funded subfirms. With gradual cancellation of geographical limitations, foreign insurance companies will, after approval, be permitted to set up branches. The qualification conditions for initial establishment do not apply to the establishment of internal branches.

Geographical Limitations

Immediately after the WTO entry, foreign life and nonlife insurance firms gained access to offer services in Shanghai, Guangzhou, Dalian, Shenzhen, and Foshan. Two years after the entry, their business could be extended to Beijing, Chengdu, Chongqing, Fuzhou, Suzhou, Xiamen, Ningbo, Shenyang, Wuhan, and Tianjin. All geographical restrictions were to be lifted three years after the entry.

Business Scope

Immediately after WTO entry in December 2001, nonlife insurers from abroad would be permitted to engage in "general insurance policies" and large-scale commercial insurance without any geographical limitation, and offer nonlife services to overseas enterprises, property insurance to foreign-funded enterprises in China, and related liability insurance and credit insurance services. Two years after the entry, nonlife insurers from abroad would be able to offer all kinds of nonlife insurance services to Chinese and foreign customers. Immediately after the entry, foreign life insurance companies would be permitted to provide individual (nongroup) life in-