China's Integration into the Global Financial System

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- *Despite its importance as an investment destination and major exporting country, China is considerably less integrated into the global financial system than might be expected.*
- *The lack of integration stems in part from China's focus on its domestic goals of balancing growth and stability while it transforms and modernizes its economy.*
- *Substantially more financial integration can be expected in coming decades, however, as China invests more abroad, develops its domestic financial system, makes its exchange rate more flexible, and further relaxes its capital controls.*

China's global economic significance is growing. Its gross domestic product (GDP) is the world's second largest when measured in terms of purchasing-power parities, and its share in world exports is exceeded only by Germany's and that of the United States. China is Canada's second-largest trading partner, and trade between the two countries is continuing to grow rapidly. China's foreign exchange reserves, now totalling US$1.8 trillion, are the world's largest. Yet China has only a minor role in the global financial system. Its banks, some of which are the largest in the world by market capitalization and the size of their balance sheets, have only a modest international presence. China's currency, the renminbi (RMB), also known as the yuan, is virtually not used outside the country and, with a few exceptions, Chinese capital markets are not a source of financing for foreign borrowers.

China's lack of integration into the global financial system needs to be understood primarily in the context of China's own interests and domestic policy priorities. The central economic goal of the Chinese authorities has been to achieve growth with stability while radically restructuring the industrial sector and creating enough jobs each year to absorb layoffs and large numbers of new entrants into the labour force. China has been generally successful in meeting these challenges, and during the past 30 years economic growth has averaged nearly 10 per cent annually. Structural and institutional reforms to free up market forces and promote efficiency are introduced gradually, with initial experimentation followed by adoption on a national scale. Industrial enterprise reforms in the late 1990s were initially experimental, followed by radical nationwide restructuring and privatization.

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Modernizing the state-owned banking system that dominates China's financial system began gradually in the late 1990s as a first step along the path towards a sound and diverse set of intermediaries and capital market institutions.

Thus, opening financial markets and integrating China's economy into the global financial system has not been a high priority in the past. As the Chinese economy matures, however, and as reforms strengthen the domestic financial system, China will become more important in global financial markets. Changes are already occurring as China's financial might is being channelled towards overseas investments and as popular pressures develop for a loosening of capital controls. The authorities have committed themselves to greater exchange rate flexibility, and this would also facilitate integration into the global financial system, while allowing continued policy focus on domestic priorities.

Our purpose here is to review the ways in which China is, and is not, integrated into the global financial system. We begin by describing the current situation and the forces that are leading to a more important role for China in world finance. This is followed by a review of China's financial system, its linkages abroad, and its current exchange rate regime. We conclude with observations on China's future direction.

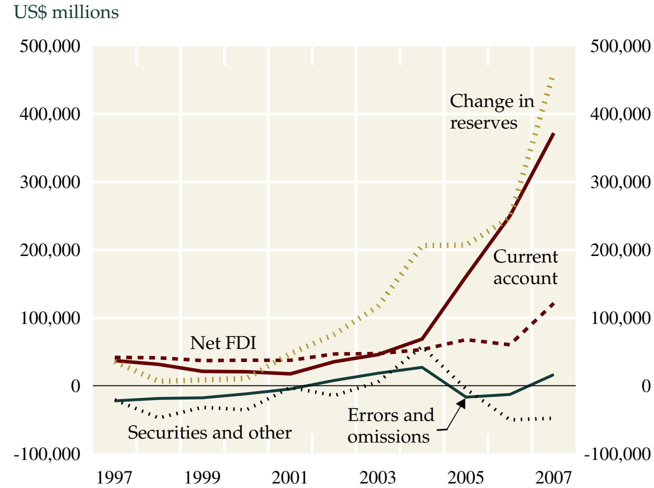
China's Capital Account

Since its accession to the World Trade Organization (WTO) in 2001, China has become one of the world's principal destinations for foreign direct investment (FDI); inflows have almost doubled since then, reaching nearly US$80 billion in recent years.[1] China's capital account is indicative of its links with the rest of the world. FDI is thus the major channel by which China accesses international capital markets. As shown in Chart 1, net FDI inflows have been relatively stable around an increasing trend over at least the past decade. In contrast, securities investments and other forms of capital flows have, until recently, been relatively small on a net basis, and have not been consistently positive or negative.

FDI inflows result from a deliberate policy to modernize Chinese industry by encouraging overseas Chinese and others to invest in China, first in the Special

Chart 1

China's Balance of Payments



Source: China, SAFE = State Administration of Foreign Exchange, downloaded from CEIC Data

Economic Zones (SEZs) and then extending to the rest of the country. The first SEZ was established in Guangdong in 1979.[2] SEZs, like export-processing zones in other countries, allow duty-free imports of inputs, and freedom from export or sales taxes; moreover, they typically provide infrastructure for enterprises to operate and lower tax rates, thus offering incentives for new investment, whether domestic or foreign. In addition, as enclaves within the still centrally planned economy, SEZs served as "laboratories" for experiments with economic reforms where the Chinese authorities could adopt more market-based regulations and use profit as an incentive without completely overhauling the economy and exposing it to world competition.

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Guangdong, as the initial beneficiary, also benefitted from its proximity to Hong Kong. Strong production links have since developed between Hong Kong and

1. Note that Chinese figures for direct investment are higher than those produced by the United Nations Conference on Trade and Development (UNCTAD), and that different Chinese sources have differing estimates of the extent of FDI. See UNCTAD (2007).

2. SEZs, and a variant known as Economic and Technological Development Zones, now number over a hundred. See Naughton (2007).

the entire Pearl River Delta as the SEZs were extended throughout the Delta region. Over time, and with further liberalization and the creation of new investment zones, multinational companies from North America, Europe, and elsewhere in Asia became substantial investors, attracted by the size of China's domestic market and the cost savings from moving manufacturing and assembly to a low-wage country with a vast pool of labour. As a result, the investment zones have industrialized quickly and have attracted substantial numbers of migrants from other parts of China.

China has benefitted from the expertise and technology associated with foreign investment, while the SEZs have provided a model for the more gradual liberalization of the rest of the Chinese economy. A less important advantage has been access to foreign financial resources per se, since China's domestic saving rate has been very high (over 50 per cent at present), and China has been running a substantial current account surplus, not a deficit, with huge reserves accumulating. To try to moderate the future trend in the balance-of-payments surplus, the Chinese government has encouraged Chinese investment abroad. Thus, outward FDI rose from US$6.3 billion in 2002 to US$27 billion in 2006. Nevertheless, China's net FDI liabilities are still far in excess of its foreign assets, while net stocks of securities and other asset categories are much smaller (Table 1). All are dwarfed, however, by China's massive official reserves, which by mid-2008 exceeded US$1.8 trillion.

Chinese investment links with Hong Kong, Korea, and its other Asian neighbours are of prime importance.

China accounted for 5.3 per cent of world FDI inflows in 2006, roughly equal to the share of Belgium, Canada, or France, and far higher than that of Germany, Italy, India, or Singapore. In contrast, its outward investment accounts for only 0.6 per cent of the world total. The destinations of those outflows also differ markedly from the world average. Most global FDI flows (84 per cent) go to developed countries, with the balance (16 per cent) going to developing countries.[3] China's outward FDI, however, is channelled overwhelmingly to developing countries (all but 6 per cent, with 2 per cent each accounted for by North America and Europe), and most going to Hong Kong and the Cayman Islands, which each receive about 35 per cent of the total. While the role of the latter as an offshore financial centre makes it likely that the FDI is destined for other countries, it is nevertheless notable that, for all the publicity given to China's investments in North America, Europe, and Africa, these destinations account for only a modest amount of Chinese investments. Instead, Chinese investment links with Hong Kong, Korea, and its other Asian neighbours are of prime importance.

Table 1

China's Foreign Assets and Liabilities

	FDI assets	FDI liabilities	Net FDI stock	Net securities	Other net	Official reserves	Overall net foreign assets
2004	52,700	369,000	-316,300	35,400	-44,900	618,600	292,800
2005	64,500	471,500	-407,000	40,100	-36,200	825,700	422,600
2006	90,600	612,500	-521,900	108,500	-48,100	1,072,900	611,400
2007	107,600	742,400	-634,800	96,900	25,100	1,534,900	1,022,100

Source: China, State Administration of Foreign Exchange, downloaded from CEIC Data

Despite its relatively modest size, Chinese FDI outside of Asia has attracted considerable media and governmental attention, which can be traced to at least three principal concerns. First, because the purchases of foreign assets are by Chinese state-owned enterprises or agencies charged with investing official reserves, there is a fear that non-commercial motives may drive investment decisions. For instance, stakes in natural resource companies may be acquired, in part to allow China to gain access to resources for geo-strategic reasons. Second, Chinese investments in Africa, in particular, are seen as undercutting conditions of good governance generally imposed by Western governments and international financial institutions, thus propping up corrupt and undemocratic regimes. Third, given the size of the economy and its massive financial resources, the potential size of future Chinese acquisitions, rather than their current importance, seems to fan public concern. The Chinese government could afford to acquire some of the world's largest multinational corporations if it chose to use even a portion of its US$1.8 trillion in reserves in this way.

Another area of interest is recent investments by Chinese financial institutions in listed foreign

3. See UNCTAD (2007). Developing countries include Eastern Europe and the Commonwealth of Independent States (CIS).

companies.[4] To date, these purchases have usually involved minority stakes (except for the investments in Asia), and in several cases (like Blackstone), the Chinese acquirer has explicitly stated that the acquisition was made for investment purposes and that it would not attempt to influence company policy. But a precedent of sorts exists. The Industrial and Commercial Bank of China's purchase of a 20 per cent stake in Standard Bank of South Africa, Africa's largest bank, is intended to serve as foundation for ICBC to become a global bank, according to its chairman. The strategy of passive investing in European and American companies may have been influenced by the unsuccessful attempt by China National Offshore Oil Company (CNOOC) to acquire outright the U.S. petroleum company Unocal in 2005 for US$18.5 billion. Congressional scrutiny and the threat that the takeover would be blocked by the Bush administration led CNOOC to withdraw its offer.

In Africa, Chinese investments have often involved government-to-government deals, with China typically acquiring rights to exploit natural resources in exchange for concessional loans and Chinese assistance in building infrastructure or providing social services (Alden 2007). Thus, China has provided financial assistance to the Sudanese government and is the country's largest investor, while the China National Petroleum Corporation (CNPC) owns the biggest share of Sudan's largest oil venture—a share giving it 150,000 barrels per day—in the southern part of the country. CNPC has helped to construct a pipeline to the Red Sea and an oil refinery in Khartoum. Similarly, China has accessed oil reserves in Nigeria and Angola, and mineral deposits in the Democratic Republic of the Congo and Zambia. In these deals, the aid and commercial elements of financing are difficult to distinguish. When projects are financed in "Angola mode," funds are not directly loaned to the recipient country; instead, the Chinese government will mandate a Chinese construction company to carry out a project, often with assistance from the Export-Import Bank of China. In exchange, a Chinese natural resources company will receive oil or mineral rights (Reisen and Ndoye 2008).

When it is making investments in mineral-rich African countries, China seems to deal primarily with regimes having governance problems, for at least two reasons. The "curse of oil" often produces governments where rent-seeking and corruption are rampant, and China, as a latecomer in the acquisition of sources of supply, most easily finds opportunities with pariah states with which Western governments discourage contact. Its dealings with these states have been facilitated by its doctrine of non-interference in other countries' sovereignty—a policy that resonates with African countries that have suffered from colonialism. China has not escaped blame from Africans themselves, however, because China's actions undercut efforts to improve governance, for instance, in the context of NEPAD.[5] China's continuing involvement with African countries has led it to modify its indifference towards governance failures and civil rights abuses. After years of unqualified support, the Chinese government recently condemned the actions of the Sudanese government with respect to the country's rebels in Darfur and has made contributions to the African Union's peacekeeping force there. Chinese officials are also increasingly distancing themselves from the government of Robert Mugabe in Zimbabwe (Alden 2007). Available data are mixed on whether Chinese involvement has reduced corruption, or instead, added to governance problems (Reisen and Ndoye 2008, 30).

Portfolio capital flows are subject to various restrictions, but there has been a trend towards their liberalization. They are still largely channelled through large institutional investors using the QFII and QDII programs.[6] When China joined the WTO, the government committed to opening its securities markets to foreign investors.[7] In December 2002, the Qualified Foreign Institutional Investor (QFII) program was introduced. Firms that meet the requirements can invest in various domestic financial instruments in China, such as treasuries, convertible bonds, corporate bonds, and A shares, which are common shares registered in Mainland China and denominated in yuan.[8] The program offers many benefits by introducing additional competition

4. Some of these investments will figure in portfolio outflows, rather than direct investment, since the latter includes only stakes that exceed a threshold percentage of an existing company or allow the investor an effective voice in its management. Chinese data are based on a 25 per cent threshold, not the 10 per cent that is the international standard.

5. The New Partnership for African Development, an initiative of the presidents of Nigeria, Senegal, and South Africa, attempts to exert peer pressure to improve governance and economic policies.

6. Qualified Foreign Institutional Investors and Qualified Domestic Institutional Investors, respectively.

7. Foreign security firms were to be permitted to engage directly in trading B shares, and foreigners were to be permitted to establish joint-venture security and funds-management companies. B shares trade and are settled in foreign currencies (in U.S. dollars on the Shanghai market, and in Hong Kong dollars on the Shenzen market) but are otherwise identical to A shares.

8. Neftci and Ménager-Xu (2007) provide a fuller description of China's financial markets.

in China's securities markets, enabling the transfer of foreign expertise, promoting a more effective allocation of Chinese savings, and increasing the attractiveness of Chinese securities for foreign investors.[9]

The QFII program is restricted to funds-management and securities companies with at least US$10 billion under management, and to the world's top 100 commercial banks.[10] As well, the securities regulator of their home country must have signed a Memorandum of Understanding and maintained a good relationship with the China Securities Regulatory Commission (CSRC).[11]

China has also moderately eased its controls on capital outflows.

China has also moderately eased its controls on capital outflows. In August 2004, the CSRC certified its initial Qualified Domestic Institutional Investors (QDIIs). Chinese insurance companies with assets of over five billion RMB are now permitted to invest up to 80 per cent of their foreign exchange funds in overseas capital markets, with some limitations. Individuals have been unable to purchase assets abroad, but the State Administration of Foreign Exchange announced in August 2007 that domestic investors would be permitted to open accounts with the Tianjin branch of the Bank of China to trade securities listed on the Hong Kong market, with extension to other banks to follow.[12] This decision was later reversed by Premier Wen, on two grounds: first, that the anticipated flows of funds might swamp the Hong Kong financial market, and second, that the proposal needed to be restructured.[13] Despite the strict controls, there is some evidence that investors are evading them. In particular, capital has at times flowed in to take advantage of expected renminbi appreciation,[14] leading to a large figure for errors and omissions in the 2003–04 balance of payments (Chart 1). On the other side, Chinese companies and individuals have transferred capital, especially to Hong Kong, in part to buy Chinese shares listed there, which trade at lower prices than in Shanghai.

China's Financial System and Its Linkages Abroad

As the foregoing discussion indicates, China is awash in capital. Households, firms, and governments are prodigious savers. Seventy per cent of Chinese savings are held in banks, compared with 20 per cent in the United States (Farrell and Lund 2006).

The financial system is bank dominated, and nearly all banks are majority government owned. The banking system includes five large state-owned commercial banks (SOCBs), a dozen joint stock commercial banks, more than 100 city commercial banks owned by municipal governments, and more than 30,000 rural and urban co-operatives (Table 2). SOCBs dominate the system, accounting for more than half of banking assets, thousands of branches, and hundreds of thousands of employees located throughout the country,

Table 2

China's Banking System, 2007

Billions of RMB

	Assets (share)	Liabilities (share)
State-owned commercial banks[a]	28,007 (53.2)	26,433 (53.3)
Joint stock commercial banks[b]	7,249 (13.8)	6,911 (13.9)
City commercial banks	3,340 (6.4)	3,152 (6.4)
Other banking institutions[c]	14,001 (26.6)	13,072 (26.4)
Total	52,598 (100.0)	49,568 (100.0)

Source: China Banking Regulatory Commission, "Total Assets and Total Liabilities of the Banking Institutions as of end–2007." Available at <http: //www.cbrc.gov.cn>.

a. Includes the Industrial and Commercial Bank, the Agricultural Bank of China, the Bank of China, the China Construction Bank, and the Bank of Communications.

b. Includes CITIC Industrial Bank, China Everbright Bank, Huaxia Bank, Guangdong Development Bank, China Merchants Bank, Shanghai Pudong Development Bank, Industrial Bank, China Minsheng Banking Corp., Evergrowing Bank, China Zheshang Bank, and China Bohai Bank.

c. Includes policy banks, rural commercial banks, foreign banks, UCCs, RCCs, finance companies affiliated with enterprise groups, trust and investment companies, financial leasing companies, auto financing companies, money brokers, and postal savings banks.

9. The opening of China's capital markets to foreign investors has followed China's traditionally cautious approach to reform, what Deng Xiaoping termed "crossing the river by feeling the stones."

10. As of the summer of 2007, 52 foreign institutions and four foreign banks had been licensed as custodian banks. See the CSRC website at <http: //211.154.210.238/en/homepage/index_en.jsp>.

11. The CSRC is the executive arm of the State Council Securities Committee, which was established in 1992 to regulate China's securities and futures markets.

12. "China Allows Direct Offshore Investments," *Financial Times*, 21 August 2007, p. 3.

13. One of its alleged flaws was that it amounted to "one bank, one city, one market," raising bureaucratic and jurisdictional objections ("Chinese Plan to Allow Purchase of Hong Kong Shares Put on Ice," *Financial Times*, 5 November 2007).

14. "World News: China Vows to Crimp 'Hot Money,' Inflows," *Wall Street Journal*, 10 March 2007.

but they are slower growing (15 per cent annually) than the joint stock banks (33 per cent) and city commercial banks (29 per cent). Privatization is gradually occurring as equity becomes more widely held by private investors and foreign strategic investors. In experimental cases in rural areas, strategic private investors are being allowed 100 per cent ownership.

China's capital markets are among the smallest in the world relative to the size of the domestic economy. There are two stock exchanges: Shanghai, established in 1990, and Shenzhen, in 1991.[15] Most of the available listings are those of the public shares of China's largest state-owned enterprises (SOEs). High levels of government ownership in these companies and segmentation of the market have limited market liquidity. The QFII program, which allows foreign investors to trade in the domestic market subject to certain restrictions that include a maximum 10 per cent equity stake in any domestic company and prohibitions on acquisitions of non-tradable state-owned shares, is aimed at partially addressing these problems.

China's bond market is at an even earlier stage of development, serving mainly as a channel for government finance, owing to the highly restrictive regime faced by corporate issuers. Although both the central bank and the Securities Regulatory Commission are the regulators, the National Development Research Council, secretariat to the policy-making State Council, until recently approved quota allocations and the issuance of corporate bonds. Banks continue to supply most debt finance. By September 2006, corporate bonds accounted for only 3 per cent of outstanding bonds, compared with the 68 per cent combined shares of government and central bank bonds (UBS 2006). Corporate issuers, especially those listed on the Hong Kong Stock Exchange, are instead tapping into overseas debt markets.

The government has worked intensively since 1998 to modernize the banking system. In 2000, the China Banking Regulatory Commission (CBRC) was created to oversee retail and wholesale banks.[16] As part of the 2001 WTO accession agreement, China agreed to open the domestic banking sector to foreigners by 2007. To ensure that banks would be competitive by then, the government took three steps. The first encouraged restructuring and recapitalization, beginning with the five large state banks. By 2005, an estimated half a trillion dollars had been spent to remove bad loans from banks throughout the system (the Agricultural Bank of China, still a work in progress, was not included in this estimate) and to inject fresh capital to bring them to Basel I levels of capital adequacy (Ma 2006). The second step encouraged participation of strategic foreign investors, not for their capital, but for their expertise and assistance in modernizing the banks. By mid-2007, some US$20 billion had been invested (Table 3). The third step, permitting these banks to list some of their shares on the stock exchanges in Hong Kong and Shanghai, was intended to encourage transparency and greater management focus on efficiency and profitability. These offerings attracted huge investor interest. The Bank of Communications, which listed in 2005, raised US$2 billion, followed by the Bank of China and the China Construction Bank, each of which raised US$9 billion. When ICBC listed late in 2006, it raised an astounding US$19 billion. By one estimate, these listings, along with domestic listings in China's A share market, have raised more than US$50 billion since 2005 (Anderson 2006).

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These measures are having an impact on bank management. Non-performing loans (NPLs) as an indicator of efficiency have improved. Among the Big Five state-owned commercial banks, NPLs dropped from 28.6 per cent (for the original Big Four) in 2000 to 8.05 per cent for the five in 2007 (CBRC 2007). The banks have yet to be tested by adverse economic conditions, however.

Banking-system efficiency and competitiveness are also inhibited by certain institutional features of the financial system.[17] China's investment-led export-oriented growth strategy relies on the stability of key prices, like the exchange rate and interest rates. Since the 1997–98 East Asian financial crisis, the exchange rate has fluctuated in a very narrow range. It has been stabilized by the central bank acquiring large foreign

15. In 1990, 10 companies had listed on the Shanghai Exchange; by the end of 2006, the number listed on both exchanges had grown to 1,500.

16. The CSRC oversees investment banks. Since the 17th People's Congress in October 2007, the formation of a single regulator has been under discussion ("China Considers Financial Superministry," *Wall Street Journal*, 10 January 2008).

17. These interconnections are traced in detail in Prasad (2007).

Table 3

Foreign Investments in Chinese Banks

Date	Chinese bank	Foreign investor	Equity share (%)	US$ millions
2002	Shanghai Pudong Dev Bank	Citigroup	15	73
2002	Bank of Shanghai	IFC/HSBC	15	145
2002	China Everbright Bank	IFC	5	19
2002–05	Bank of Nanjing	IFC/BNP Paribas	25	114
2004	Industrial Bank	Hang Seng/ IFC/GIC	25	326
2004	China Minsheng Banking Corp.	IFC/Temasek	6	125
2004	Shenzhen Development Bank	Newbridge	18	150
2004	Xi'an City Commercial Bank	IFC/Scotiabank	25	40
2005	Jinan City Commercial Bank	Commonwealth Bank	11	17
2005	Bank of Beijing	IFC/ING	25	270
2005	Hangzhou City Commercial Bank	Commonwealth Bank/ADB	25	110
2005	Huaxia Bank	Deutsche/ Sal Oppenheim	13	325
2005	Bohai Bank	Standard Chartered	20	125
2005	Bank of Communications	HSBC	20	1,750
2005	China Construction Bank	Bank of America/ Temasek	14	4,000
2005	Bank of China	RBS/UBS/ Temasek/ADB	17	5,175
2005	Tianjin City Commercial Bank	ANZ	20	110
2005	Industrial and Commercial Bank of China	Goldman/ Allianz	10	3,700
2006	Ningbo Commercial Bank	OCBC	12	70
2006	Shanghai Rural Commercial Bank	ANZ	20	252
2006	United Rural Cooperative Bank of Hangzhou	Rabobank/IFC	15	30
2006	Chongquing City Commercial Bank	Dah Sing/ Carlyle	25	130
2006	Guangdong Development Bank	Citigroup/IBM	25	760
2007	CITIC Industrial Bank	BBVA	5	650
2007	Dalian City Commercial Bank	Scotiabank/IFC	25	320
Total				18,786

Source: Ma (2006), IMF, Xinhua, *China Daily*, UBS estimates

exchange earnings from exports and FDI inflows and sterilizing the resulting liquidity. These practices have reduced the independence of monetary policy. Rather than allowing banks' loan and deposit interest rates to be market determined, the central bank must administer them, offering savers low returns and allowing the banks healthy spreads by setting higher lending rates. Allowing market-determined rates would be risky, since the fixed exchange rate is vulnerable to speculative capital inflows, which would put upward pressure on the exchange rate and require more sterilization. Administered interest rates were ineffective in slowing growth in 2007, but an outright prohibition on new lending towards the end of the year did slow credit expansion.[18] Administered interest rates also reduce commercial banks' appetite for risky credits because these banks can rely for a good part of their income on large well-known borrowers with government connections and on the generous administered spreads between deposit and lending rates.[19]

Banking-system efficiency is also influenced by continued government ownership. Since 2004, prudential standards and oversight have been strengthened and incentive structures for bank managers have been modernized. But incentive structures have not changed sufficiently to make the banks' overlending (mainly to state-owned enterprises) a thing of the past. The large banks continue to rely on traditional mainstay borrowers, which are firms, many of them owned or controlled by the government. According to the large banks' own published financial statements, corporate customers still account for between 70 and 80 per cent of their loans (Dobson and Kashyap 2006). The implication is that banks are exposed, not to firms with burgeoning profitability, but to tens of thousands of government-owned or -controlled firms whose profits are likely to be less certain in an economic downturn.

All of this means that governance in China's majority government-owned banks is a work in progress that affects incentive frameworks. Steps have been taken to increase representation by independent directors on boards, but the involvement of Communist Party officials, while declining, continues to be pervasive. Bank

18. By August 2007, the People's Bank of China had raised interest rates four times in its attempt to curb price increases, rising asset values, and overcapacity in manufacturing, yet the economy expanded nearly 12 per cent in 2007Q2, the strongest growth in 12 years (Zhang Tao, "Deal with Inflation, Currency Threats, Chinese Central Banker Warns," *National Post*, 29 August 2007, p. FP18).

19. Dobson and Kashyap (2006) illustrate the size of the spread and discuss its impact on bank business plans.

heads are members of the Central Committee (Naughton 2003); the CEO is often also the party secretary; and bank performance is discussed at party meetings.

Short-term profitability masks the problems that lie ahead.

The management, ownership, and governance weaknesses mentioned above co-exist with the belief among investors, depositors, and customers that China's government-owned banks are "too big to fail." The increasing numbers of banks listed on stock exchanges are subject to more external monitoring, but continued political pressures undermine their efficiency. Indeed, the economic and credit booms since 2002 have tested their ability to evaluate and monitor new loans; bank loans have soared (reducing ratios of NPLs) in response to robust demand in expanding industries. Short-term profitability masks the problems that lie ahead. Such indicators suggest that banks are also making commercial decisions, but it takes time for these loans to mature, and should China experience slower growth, as is increasingly likely in the next few years, nonperforming loans are likely to increase and to create stress on the banks. Yet depositors believe they have blanket protection of their deposits, even if the rate of return is low. The People's Bank of China is not independent, so there is widespread confidence in it as a lender of last resort.

Once all of the major banks have been restructured, market forces are likely to be freed up, borrowing and lending rates deregulated, interest spreads will shrink, investor and depositor monitoring will intensify as the implicit blanket guarantee is modified or removed, and banks will face stiffer competition from the developing capital market institutions. As margins shrink and balance sheet growth declines, pressures to consolidate the banking sector are likely to follow.

In the meantime, banks are flush with cash. The Industrial and Commercial Bank of China (ICBC) and the Bank of China have joined the world's top 10 banks, as measured by tier one capital,[20] and the government is encouraging banks to "go abroad" to develop global capabilities. In September 2007, central bank governor Zhou Xiaochuan outlined the government's supportive policy framework. It includes fostering the development of the foreign exchange market to help enterprises manage interest rate and exchange rate risk; reduced controls on foreign exchange transactions; assistance to qualifying financial enterprises to establish overseas operations; and development of "regional financial platforms" through co-operation with regional development banks (Zhou 2006).

In the past year, financial enterprises have used three channels for their investments (Table 4). One is to follow their customers into developing countries. In Asia, which is familiar territory, Chinese banks have taken large stakes. ICBC has a majority stake in Bank Halim Indonesia and Macau Seng Hang Bank; Bank of China owns Singapore Aircraft Leasing outright. ICBC is following its corporate customers into Africa and, along with China Development Bank's China-

20. "Top 1000 World Banks" (annual), *The Banker*, July 2007.

Table 4

Foreign Investments Announced by Chinese Financial Institutions

Date	Chinese bank	Target	Equity stake (%)	Estimated value (US$ millions)
December 2006	Bank of China	Singapore Aircraft Leasing	100.0	965
December 2006	Industrial and Commercial Bank of China	Bank Halim Indonesia	90.0	10
May 2007	China Investment Corporation	Blackstone	9.9	3,000
May 2007	CDB	China-Africa Development Fund	100.0	1,000
July 2007	China Development Bank	Barclays	3.1	3,100
August 2007	Industrial and Commercial Bank of China	Seng Hang Bank (Macau)	79.9	583
October 2007	CITIC Securities	Bear Stearns*	6.0	1,000
October 2007	China Minsheng Banking Corp.	UCBH (San Francisco)	9.9	317
October 2007	Industrial and Commercial Bank of China	Standard Bank of South Africa	20.0	5,600

* Transaction was cancelled because of the takeover of Bear Stearns by JPMorgan Chase & Co. in March 2008.

Source: Reuters, *Financial Times*, *China Daily*

Africa Development Fund, is financing infrastructure and building ties with African governments and enterprises in China's search for natural resources and new markets. ICBC's investment in Standard Bank of South Africa, Africa's largest bank, gives it a platform with an experienced partner to assist its penetration of an unfamiliar geography.

The second channel is to take stakes in more sophisticated banks in the United Kingdom and the United States to increase international competitiveness by learning advanced banking technologies and products. In these cases, the stakes are small, in part to avoid political friction. The fates of the first four investments are mixed and suggest that there is still much to learn. In October 2007, CITIC Securities agreed to acquire 6 per cent of Bear Stearns, the U.S. investment bank struggling with its mortgage business, which would provide a 2 per cent stake in CITIC in return. When Bear Stearns became insolvent in March 2008 and JPMorgan Chase stepped in as its acquirer, CITIC Securities cancelled its deal. China Investment Corporation (CIC) took a stake in the IPO of Blackstone, the U.S. private equity firm, in May 2007. CIC was widely criticized in Beijing for having paid too much when the share price dropped following the IPO. China Development Bank's July 2007 investment in Barclays included an agreement to invest further if Barclays' bid for ABN-Amro succeeded (it did not). The one investment that appears to be structured for successful learning and partnership is China Minsheng Bank's stake in UCBH Holdings (a San Francisco-based bank that focuses on the ethnic Chinese population in the United States and abroad), acquired in October 2007. Each party acquires the right to board representation in the other, and Minsheng can increase its investment in the future if it receives U.S. regulatory approval.

The third channel for foreign investment is market entry through a banking licence. Both ICBC and China Merchants Bank have applied to the Federal Reserve for U.S. banking licences but have been met with caution, reportedly because of concerns about governance, transparency, and the absence of a legal framework to deal with money laundering. The CBRC has indicated a linkage between the Chinese government's stance on opening wider the door to foreign investors in China's banks and the willingness of other governments to grant banking licences to Chinese applicants.[21]

21. "Beijing in Call for US Banking Licenses," *Financial Times*, 24 September 2007.

In summary, with variable success, Chinese financial institutions have used their growing foreign linkages primarily as a means to increase their efficiency and competitiveness. As China's financial system is further modernized, the banks will face stiffer domestic competition, which will reduce margins and shrink balance sheets, likely resulting in domestic consolidation in the years ahead. It is reasonable to expect, therefore, that only the strongest "brand" candidates will likely be permitted to participate in China's "go abroad" drive. Even then, the available evidence suggests that there is still much to be learned about operating outside of East Asia. Initial investments are still small in financial terms, but they incur reputational risks and add operational complexity. As the domestic environment becomes more competitive, even adverse, banks' abilities to manage these international investments will be tested.

China's Exchange Rate Regime

Most large economies have flexible exchange rates, which free up the central bank to pursue domestic objectives. Pegged exchange rates in a context of highly mobile capital can be fragile, because they can be subject at times to strong speculative pressures for a devaluation or revaluation. The crises in the European Monetary System and in Mexico and East Asia in the 1990s have led most of the larger emerging-market economies to abandon exchange rate pegs and embrace exchange rate flexibility—if not complete flexibility in all cases. China retains extensive capital controls and has a managed exchange rate, but has embraced the principle of greater exchange rate flexibility.

The evolution of China's exchange rate regime has been gradual. In 1994, the official and parallel[22] exchange markets were unified, and the official RMB–dollar exchange rate was devalued sharply following a period of sustained inflation and loss of international competitiveness. The exchange rate has been stable since then, particularly during the turbulent period of the Asian crises in 1997–98.[23] On 21 July 2005, a managed floating exchange rate regime was introduced, and the RMB was allowed to move within a narrow range in reference to an unspecified basket of currencies. Recognizing that Chinese enterprises

22. Applying to non-trade transactions not officially encouraged, and taking place at a more depreciated exchange rate.

23. China's decision not to engage in competitive devaluation to match those of its regional trading partners was widely appreciated in the region, earning China political dividends.

would have to learn to manage associated exchange rate risks, new instruments were introduced to enhance the operations of the foreign exchange market, including an over-the-counter market and foreign exchange and interest rate swaps. From that date until the end of May 2008, the RMB has appreciated by 14.4 per cent in terms of the U.S. dollar, but much less in real effective terms (since most other major currencies have appreciated against the dollar) despite China's large and growing trade surpluses and substantial capital inflows (Chart 2).

Since 1992, China has increasingly become a magnet for foreign investors attracted to its large domestic market and abundant supplies of low-cost, educated labour. China is now the world's third-largest trading nation, exporting labour-intensive manufactures assembled there and importing natural resources, manufactured components, and capital-intensive goods. The speed and magnitude of China's export growth has contributed to a large trade surplus, averaging about 9 per cent of GDP in 2006 and 2007 (Chart 3).

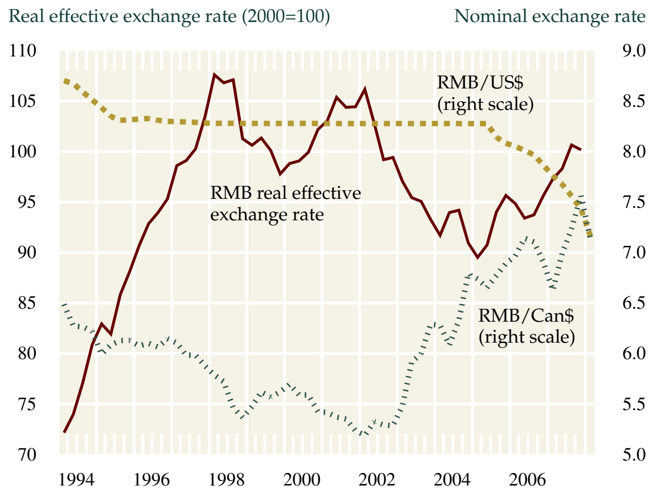
Chinese government concerns about the domestic consequences of large or rapid revaluation are paramount.

In this context, China's stable exchange rate is the subject of prolonged international debate. Some call for greater exchange rate flexibility (Eichengreen 2005), while others call for a one-time revaluation (Goldstein and Lardy 2006). China's trade gains, which have not been reflected in a substantial appreciation of its currency, have come from its comparative abundance of low-cost labour whose productivity is growing. To the Chinese government, concerns about the domestic consequences of large or rapid revaluation are paramount; namely, fear of disruptive adjustment for exporters of labour-intensive manufactures and risks to the low-productivity agricultural sector (on which large numbers of Chinese still depend for employment) from increased import competition.

Large Chinese surpluses need to be seen in the context of global imbalances and, in particular, large U.S. current account deficits.[24] As many have pointed out, including central bank governor Zhou Xiaochuan, balancing China's trade will not by itself resolve the problem of the U.S. current account deficit, which reflects a fundamental savings-investment imbalance. In an attempt to coordinate a solution to the problem of global imbalances, the International Monetary

Chart 2

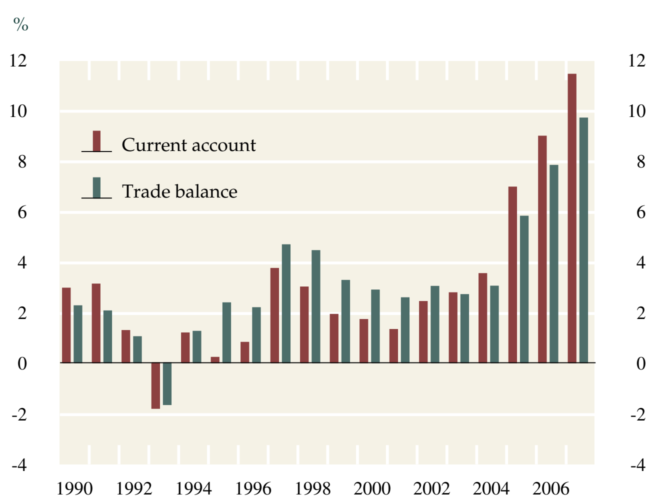
China's Real Effective Exchange Rate and Bilateral Rates with Canada and the United States



Source: IMF *International Financial Statistics*

Chart 3

China's Trade and Current Account Balance as a Percentage of GDP



Source: IMF *International Financial Statistics* (1990–2006), China, SAFE, downloaded from CEIC data (2007)

24. IMF (2007a). For additional insights on why global imbalances are a source of concern, see Dodge (2006a, b) and Little and Lafrance (2006).

Fund has begun multilateral discussions with key players (IMF 2007b). For their part, high-level U.S. and Chinese officials have met many times to try to resolve their differences with respect to trade imbalances and the RMB-dollar exchange rate but, to date, agreement on specific measures has been limited.

China's emphasis on exchange rate stability in the face of rising current account surpluses has forced the central bank to accumulate massive foreign exchange reserves, producing unfavourable domestic consequences as well as generating protectionist pressures abroad.

The accumulation of international reserves on a central bank's balance sheet typically finds its counterpart in monetary expansion, unless these reserves are sterilized, i.e., are not allowed to affect the domestic economy.[25] Sterilization may levy a heavy fiscal cost and introduce distortions into domestic financial systems (Mohanty and Turner 2005). The fiscal costs stem from the fact that the yields on sterilization bonds are typically higher than the returns earned on foreign reserves. While this has not been a problem for China, the recent fall in short-term U.S. Treasury rates has increased the financial burden on the central bank. Moreover, China is exposed to large capital losses on its foreign reserve holdings (which are believed to be largely held in U.S. dollars) as the RMB appreciates.

For these reasons, a key issue for China, given its current level of integration into the international financial system, is when and how to change the exchange rate regime. Eichengreen et al. (1999) argue that international experience shows that the best time to exit from a fixed exchange rate is while capital is flowing into a country. By adopting a *de facto* (as well as a *de jure*) flexible exchange rate, China would gain greater leverage to limit deviations of inflation and growth from chosen targets by means of a monetary policy geared to domestic objectives. An independent monetary policy would allow interest rates to be market determined, which would help in modernizing the banking system, as discussed above. Such a policy does not imply neglecting the exchange rate; it may involve intervening in the exchange market to limit short-run currency fluctuations, but not to resist longer-term trends.

25. There are two main ways to sterilize foreign reserves: either by reinvesting the funds directly abroad, which is basically what a sovereign wealth fund does; or by draining funds from the national banking system by forcing them to hold either government or central bank bonds. So far, China has mainly relied on the latter method, although it has recently created a special fund for foreign investments, the China Investment Corporation, with an initial endowment of US$200 billion.

Eichengreen (2005) points out that a rapid transition to a more flexible exchange rate is not an argument for rapid capital account liberalization. History is replete with examples of countries that have operated managed floats while retaining capital controls (e.g., Europe in the 1930s, Japan in the 1970s, Chile in the 1990s, Brazil and India today).

A key issue for China is when and how to change the exchange rate regime.

Greater exchange rate flexibility would facilitate the liberalization of the capital account by better preparing the economy to deal with the impact of increased volatility associated with freer capital flows. One of the main lessons China drew from the Asian financial crisis is that financial system development and capital account liberalization should be carefully sequenced to allow for the institutional development necessary to manage the additional risks. Studies of countries' experiences have demonstrated that capital account liberalization has to be supported by a combination of sound macroeconomic policies to contain aggregate financial imbalances and sound prudential policies, backed by adequate supervision of the financial system, to ensure proper incentives for risk management (Eichengreen et al. 1998). In summary, the adoption of a monetary policy aimed at domestic objectives would facilitate various reforms that would contribute to China's central domestic goals, a sound and diverse financial system, and greater transparency and effectiveness of monetary policy in its pursuit of low inflation.

Conclusions

China is considerably less integrated into the global financial system than its importance as an investment destination and major exporting country might suggest. These features are best understood in the context of China's overarching domestic priorities to create sufficient modern-sector jobs as it restructures the economy and moves people out of low-productivity agriculture while maintaining political and social stability. China's rapid economic development is likely to lead to substantially more financial integration in coming decades, however, as China invests more abroad, develops its domestic financial system, and relaxes further its capital controls.

The question of the proper sequencing of domestic financial reforms, exchange rate flexibility, and capital account liberalization naturally arises. Capital controls protect Chinese banks from the risks of foreign currency mismatches that were so harmful to the financial systems of the countries affected by the Asian crisis during the late 1990s.[26] Outward FDI by Chinese banks and SOEs will require further capital account liberalization, however, as Chinese banks also increase their foreign currency business with Chinese companies.

A stable RMB has helped to further the development of China's industrial base, but the managed exchange rate regime has constrained monetary policy, a problem that still needs to be addressed. Greater exchange rate flexibility, allowing a faster appreciation and reducing currency undervaluation, will be necessary to encourage Chinese enterprises to rely more on productivity than on price competitiveness in international markets, to prevent further accumulation of reserves, and to defuse growing protectionist pressures, particularly in the United States and Europe.

While capital account liberalization is likely to continue, leading to greater integration with the global financial system, some elements should be postponed until domestic institutions have further developed their abilities to assess and mitigate risks; supervision and regulation are strengthened; and domestic financial markets develop further.

26. Principally Thailand, Malaysia, Indonesia, and Korea.

Much will depend on whether the Chinese authorities are interested in seeing the currency in wide international use.

A more distant issue is when and whether the Chinese currency will play a role on the world stage that is comparable to the size and rate of growth of China's trade (Dobson and Masson 2008). At present, the RMB is not used outside of China except for a modest amount of renminbi balances held at Hong Kong banks. The first step towards more international use of the currency can be expected in East Asia, where it is likely to be used for invoicing and settlement of trade. As capital controls are gradually liberalized, the next step might be the growth in foreign holdings of RMB-denominated assets, followed by RMB borrowing by foreigners in China's capital markets. In the long run, however, much will depend on whether the Chinese authorities are interested in seeing the currency in wide international use. This is still an open question, but it can be argued that, even if the authorities were interested, the RMB will not gain international importance until China has a sophisticated and sound domestic financial system buttressed by an independent central bank, a flexible exchange rate, and open capital markets.

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