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# Freeing up the Dragon – Can financial liberalization in the People's Republic of China be considered a factor of further political liberalization?

# 自由之龙——中国的金融自由将会是进一步政治自由的前奏?

Natalie Bertsch

Konrad-Adenauer-Stiftung
德国阿登纳基金会

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**Editor:**
Project Office of the Konrad Adenauer Foundation in the PRC
Office C 813, Beijing Lufthansa Center
No. 50, Liangmaqiao Road, Chaoyang District, Beijing 100016
Tel.: 0086-10-6462 2207/08
Fax: 0086-10-6462 2209
E-mail: beijing@kaschina.com.

Room 1901, Overseas Chinese Mansion
No.129, Yan'an Xi Road, Shanghai 200040
Tel.: 0086-21-6249 1722/2714
Fax: 0086-21-6249 4549
E-mail: shanghai@kaschina.com.

Webpage: www.kas.de

**Responsible:**
Winfried Jung, Thomas Awe

**发 行**：德国阿登纳基金会中国项目执行人
**地 址**：北京市朝阳区亮马桥路 50 号燕莎中心写字楼 C813 室
**邮 编**：100016
**电 话**：0086-10-6462 2207/08
**传 真**：0086-10-6462 2209
**E-mail**：beijing@kaschina.com

**地 址**：上海市延安西路 129 号华侨大厦 1901 室
**邮 编**：200040
**电 话**：0086-21-6249 1722/2714
**传 真**：0086-21-6249 4549
**E-mail**：shanghai@kaschina.com.

**主 页**：www.kas.de/china
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# 目录

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## Can financial liberalization in the People's Republic of China be considered a factor of further political liberalization?

"The Europeans and Asians now rushing to do business in China, try to convince themselves, just as Americans do, that China is changing, that their trade and investment are helping to bring political liberalization to China." Or as President Bush declared in one of his earliest foreign policy speeches in November 1999: "Economic freedom creates habits of liberty. And habits of liberty create expectation of democracy."[1]

There is a broad consensus that the People's Republic of China is liberalizing its financial sector, which constitutes the last step of the economic transformation process having been kicked off nearly three decades ago by former President Deng Xiaoping.

The objective of this paper is to analyze whether financial liberalization in the P. R. China will or already have had an impact on the political system and whether or not these reforms will lead to more political freedom for its citizens in the future.

Political liberalization or political freedom cannot be defined in this context with strict terms of one party system versus a multi-party system full fledge democracy. It is assumed that any political changes in the P.R. China will be slow for the sake of preventing chaotic and quick democratization process such as observed after the collapse of the Soviet Union. Therefore political liberalization is referred to as a greater freedom of speech, including a free press and direct election on higher levels than the current-one[2] or generally any cease of control or power of the Chinese Communist Party.

Firstly, the paper shall establish an overview of the state of the financial sector in the P. R. China and the pace of reforms. In section two, the financial sector reform will be analyzed with regard to the banking sector, capital market sector and the exchange rate

[1] James Mann, The China Fantasy-How our leaders explain away Chinese repression, Viking, 2007.

[2] In the People's Republic of China direct democratic elections take place on the village and community level, but not on the higher levels such as the county, provincial and national level.

regime.

*Conclusion-financial sector reform in the PR China*

The banking system might have seen the biggest part of the formal reform process while it is still lacking a commercial credit culture. The securities market, although achieving the first steps of liberalization, still has to open up to foreign investors to grow into a more liquid and rational market. Opening up to foreign investor is closely linked with what is considered to be the next big step in the reform of the whole financial sector: the liberalization of the exchange rate system. The internationalization and convertibility of the Renminbi is a sensitive issue and might take up to 5 years to be carried out. Although the three sectors of the financial system are differently advanced, they share one feature in common: public ownership and guidance through macro control measures. In order to establish a sound and efficient financial system market forces rather than macro-control measures and privatized banks, companies and an independent Central Bank rather than public ownership should run the financial system. Lastly, market forces and private ownership then have to bring a change to the composition of the financial sector which still heavily depends on the banking sector as an instrument of financial intermediation whereas mature financial markets rely more on capital markets.

*Conclusion-impact financial liberalization on political reform*

Financial liberalization in the P.R. China can be considered a factor of further political liberalization depending on if and when the Chinese Government needs an efficient and sound financial system on the Mainland China. While reforms have been successfully implemented, government intervention in the form of state-ownership and control, regulation and corruption are the main impediments to the establishment of a sound commercially orientated financial system. Indeed, the government slowly admits market forces but still remains in final control of the financial system and its pace of reforms. This is because the government has to remain in control of the financial system to serve different and adverse socio-economic interests in order to guarantee its grip on power. Consequently, if one day the government will be in need of an efficient financial system, it has to cease control over the financial system and will, thus, loose — to some important extent - the ability to serve different socio-economic interests. This, in turn, could trigger social unrest, possibly involving a substantial loss of power of the Chinese Communist Party. The establishment of an efficient and developed financial system would additionally require the Chinese Communist Party to actually fight corruption, which in the given context seems only enforceable through political concessions in the form of freer press and/or more direct elections. Furthermore, the Chinese economy will require either in the short or the long run an efficient and sound financial system. In the short-run scenario, involving financial liberalization caused by very high inflation or a financial crisis, the Chinese Communist Party would probably have to cease more power than in the long-run scenario.

Simply because in the long run socio-economic interests will supposedly be more converged and thus, the loss of control over financial resources is politically less dangerous for the Chinese Communist Party. In the long-run, an efficient financial system needs to support the increasingly sophisticated and upgrading Chinese economy. Hong Kong as international financial center will most likely help to postpone the timing of its implementation. Currently, the risk of overheating and inflation seems under control. Accordingly, the long-run scenario seems more likely to happen. An international or national crisis, however, involving or not the use of force could change all the settings on which the arguments of this paper are based. Overall, financial liberalization can be considered a factor of political liberalization in the People's Republic of China depending on the timing and the circumstances of the former taking place and the respective policy responses of the Chinese Communist Party to a national or international crisis.

# EXECUTIVE SUMMARY

The objective of this paper is to analyze whether financial liberalization in the People's Republic of China will lead to more political freedom for its citizens. The findings suggest that the government is slowly admitting market forces but still remains in final control of the financial system and its pace of reforms. This paper argues that financial liberalization could lead to increased political freedom depending on if and when the P. R. China needs an efficient and sound financial system on the Mainland. If the financial system has to be truly liberalized, the government would have to cease control of the financial system. Accordingly, the Chinese Communist Party would loose-to some important extent- the ability to serve the different and adverse socio-economic interests in the country, which, in turn, could trigger social unrest and undermine its grip on power. An efficient financial system would additionally require the Chinese Communist Party to actually fight corruption, which in the given context seems only enforceable through political concessions. This paper further argues that the Chinese economy will require either in the short or the long run an efficient and sound financial system. In the short-run scenario, involving financial liberalization caused by very high inflation or a financial crisis, the Chinese Communist Party would probably have to cease more power than in the long-run scenario. An international or national crisis, however, involving or not the use of force could change all the settings on which the arguments of this paper are based. Overall, financial liberalization can be considered a factor of further political liberalization depending on the timing and the circumstances of the former taking place and the respective policy responses of the Chinese Communist Party to a national or international crisis.

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## 1) Introduction

"The Europeans and Asians now rushing to do business in China, try to convince themselves, just as Americans do, that China is changing, that their trade and investment are helping to bring political liberalization to China." Or as President Bush declared in one of his earliest foreign policy speeches in November 1999: "Economic freedom creates habits of liberty. And habits of liberty create expectation of democracy."[3]

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[3] James Mann, The China Fantasy-How our leaders explain away Chinese repression, Viking, 2007.

[4] In the People's Republic of China direct democratic elections take place on the village and community level, but not on the higher levels such as the county, provincial and national level.

power of the Chinese Communist Party.

Firstly, the paper shall establish an overview of the state of the financial sector in the P. R. China and the pace of reforms. In section two, the financial sector reform will be analyzed with regard to the banking sector, capital market sector and the exchange rate regime.

Secondly, section three of this paper shall define whether or not current financial sector transformation — as defined in section two — will bring greater political freedom to the P. R. China. Simply, whether the P. R. China will combine a liberalized financial with greater political liberalization (like in the case of South Korea and Taiwan) or not (like Singapore, where despite financial and economic openness an autocratic system was able to persist)?

## 2) China financial sector reform

The beginning of this financial reform is mainly associated with Zhu Rongji, Vice Premier and Premier under former President, Jiang Zeming from 1991 to 2002. "Concurrently serving as governor of the Central Bank, Zhu tackled the problems of an excessive money supply, rising prices, and a chaotic financial market stemming, in large measure, from runaway investments in fixed assets in the beginning of the 1990'ies. After four years of successful macro-economic controls with curbing inflation as the primary task, an overheated Chinese economy cooled down to a "soft landing"."[5]

Since the Chinese economy, even after this "soft landing" remained on the brink of overheating, further reforms have been undertaken in all sectors of the financial system. Before, however, providing an overview and assessment of the reforms in the banking sector, the capital markets and monetary policy, it is necessary to comment on the composition of the financial sector in the P.R. China. Total financing of households, enterprises and government sectors, as of 2006, is carried out 86.8%[6] trough bank loans. The equity market provides a total of 5.6%[7] of all capital, whereas corporate bonds and government securities contribute 7.5%.[8] In comparison with developed fi-

[5] http://en.wikipedia.org/wiki/Zhu_Rongji, looked up on the 27. August 2007.

[6] http://en.wikipedia.org/wiki/Zhu_Rongji, looked up on the 27. August 2007.

[7] http://en.wikipedia.org/wiki/Zhu_Rongji, looked up on the 27. August 2007.

[8] Deutsche Bank Research, *China's banking sector: ripe for the next stage?* 2007 December 2006.

nancial markets whereas the majority of companies are financed through the capital markets, in the P.R. China they remain underdeveloped and financial intermediation is carried out mainly through the banking sector. Consequently, one should bear in mind the composition of the overall financial system when analyzing the reforms in the single sectors. Additionally, one should not forget that the P.R. China pursue a unique development strategy and has no historical example to follow or to learn from. While comparing the achievements of reforms to international standards of developed financial systems, this paper also clearly acknowledges the specific difficulties of reforming the financial sector in the P.R. China.

2.1) Reform and liberalization of the banking sector

The banking system of the P.R. China is extensive in terms of the number of financial institutions yet ailing and fragile. Commercial lending is carried out by a variety of 30,000[9] banking and financial institutions which are either state or private-owned and are run on different geographical scopes. The main categories of banks are the nation wide running state-owned and joint-stock commercial banks, geographical restricted city commercial banks, rural commercial banks and rural credit cooperatives. However, even the private-owned joint stock banks are held by different shareholders, mostly by state-owned companies, so that directly and indirectly the state owns almost all banks.

Additionally, most banks are effectively run by a Party Committee established in the internal management structure of the State-owned banks. Consequently, the lending strategy during decades has been politically orientated channeling loans from state-owned banks to state-owned enterprises. Until today, it remains nearly impossible for middle-size (private) entrepreneurs to obtain financing from domestic banks. Therefore, they have to find alternative investments in the form of loans from relatives and friends or illicit underground banks. As much as a third of the loans to small and medium-sized enterprises (SMES) and 55% of the loans to farmers are provided by underground banks.[10] These facts point to the lack of commercial credit culture in the Chinese Banking sector. As lending decisions were not commercially driven, a huge amount of non-performing were piled up. Non-performing loans are loans which can't be paid back by the lender, implying a loss on the Bank's balance sheets. The Chinese

[9] GIC, *Financial Service*, p. 586, figure relates to October 2005.
[10] The Economist, *Black-market banking*, 11 August 2007.

banking sector was suffering from such a huge burden of non performing loans that it threatened the stability of the whole banking system and the government was urged to undertake reforms.

Firstly, reforms have been implemented over the last two decades, " replacing the monobank system with a multilayered system that separates commercial lending and central bank functions".[11] In 1995, a two-tier banking system was legally[12] established with the People's Bank of China as central bank given the responsibilities over monetary and exchange rate policy.[13] In March 2003, the government decided to separate the supervisory responsibilities of the People's Bank of China for the banking institutions, asset management companies, trust and investment companies and other depository financial institutions. Hence, the China Banking Regulatory Commission was established to supervise the financial industry.[14] By the end of March 2007, the four state-owned commercial banks represented 55% of all bank assets; establishing their importance in the stability of the overall banking system. Therefore, the center piece of further bank reform has been (in a second step) the restructuring and recapitalization of the 4 state-owned commercial banks. The reform of the fourth state-owned bank, the Agricultural Bank of China, joint-stock commercial banks, policy banks and rural credit cooperatives has, however, not been accomplished yet. Thirdly, the banking system has been further liberalized by opening it to foreign competition. Hence, foreign banks have been given access to the Chinese Mainland banking system, thereby, infringing fiercer competition on domestic banks and pushing for further reforms.

For concerns of relevance the paper will not explore the separation between central bank and commercial activities, but rather focus on the other two liberalization steps.

<u>Reform of domestic banks</u>

*State-owned commercial banks*

In 2003, the reform of the state-own com-

[11] Richard Podpiera, *Progress in China's Banking Sector Reform: Has Bank Behaviour Changed?*, IMF Working Paper 06/07, 2005.

[12] PBC was established on December 1, 1948 based on the consolidation of the former Huabei Bank, Beihai Bank and Xibei Farmer Bank. In September 1983, the State Council decided to have the PBC function as a central bank. The Law of the People's Republic of China on the People's Bank of China passed by the Third Plenum of the Eighth National People's Congress on March 18, 1995 legally confirmed the PBC's central banking status.

[13] Deutsche Bank Research, *Challenges in monetary policy*, 14 May 2003.

[14] People's Bank of China, *History*, http://www.pbc.gov.cn/english/renhangjianjie/history.asp, looked up on 27 August 2007.

mercial banks followed a four step-model towards a "commercial credit culture"[15]. Firstly, the three biggest state-owned commercial banks, Bank of China, China Construction Bank and the Industrial and Commercial Bank of China[16], have been recapitalized with foreign exchange reserves worth USD 60 billion. It is estimated that in reality up to USD 500 billion have been spent on recapitalization. Secondly, the ownership structure has been changed to a shareholding one. While the three major banks have been turned into private legal identities, it is important to keep in mind that they remain under majority control of the State (as major shareholder). Furthermore, corporate governance improvement with regard to risk management, risk control and efficiency has been implemented. Thirdly, in order to gain greater knowledge and raise capital strategic foreign investors[17] have been brought in. Lastly, stock market listings of these three banks in Shanghai and Hong Kong in 2005 and 2006 were intended to infringe market discipline on them. The reform of the fourth state-owned bank, Agricultural Bank of China, is still in progress, however, containing problems mainly related to property rights of rural assets. The Agricultural Bank of China hold the majority of its assets in the countryside, thus, given the system of state and collective ownership, it is difficult to trade them on the markets. If the assets want to be traded in the market, collective land would have to be confiscated from peasants, politically sensitive to undertake. The pace of its reforms, however, has been speeded up and a bailout, worth 140 billion USD, from the central government, is expected to take place in the second half of this year.[18]

*Other commercial banks*

Joint-stock banks and city commercial banks have started to reform themselves. While the government is reluctant to support the reform of joint-stock banks, injections of new funds have been generated by strategic foreign investors and stock market listings. The joint-stock banks with foreign partners are improving their risk management and internal control system. As far as city commercial banks are concerned, local government played an important role in their recapitalization. So should strategic investors and initial public offerings.

The first examples are the Initial Public

[15] Deutsche Bank Research, *China's Banking sector: Ripe for the next stage?* 7 December 2007.

[16] Bank of China and China Construction Bank have been recapitalized in December 2003, whereas the Industrial and Commercial Bank of China has been recapitalized in April 2005.

[17] Foreign ownership of domestic banks is limited to 25% and to 20% for a single foreign investor.

[18] Zhang, Maggi: *Market still waits for ABC restructuring plan*, Shanghai Daily, 2 July 2007.

Offering's of Ningbo and Shanghai Bank taken place in mid 2007. More listings on the stock market are expected from other city commercial banks in 2007[19].

*Rural banks and rural credit cooperatives*

The rural credit cooperatives, responsible for most lending to rural projects and dwellers, are in a particular bad financial state. Therefore, the central government injected some USD 21 billion in the recapitalization of these banks[20].

Internal structure has also been improved by merging several rural credit cooperatives to rural commercial banks. Some of the rural institutions have even accomplished to find strategic investors such as the Shanghai Rural Bank with Australia and New Zealand Bank. Finally, the Postal Savings Bank was set up at the end of 2006 to become a major player in the rural financial sector.

*Policy Banks*

Further announcements to commercialize China Development and Policy Banks had been made earlier in 2006.[21]

The success of the implemented reform will be questioned in the next sub-section.

*Assessment of reforms*

Two reliable indicators of measuring the effectiveness and soundness of a banking system are the non-performing loan ratio and the capital adequacy ratio. International standards for non-performing loan ration are under 2-3% and an adequate capital requirement is, according to the reference of international banking standard Basel II, 8% as a minimum threshold. According to official statistics from the People's Bank of China, non performing loan ratio of the state-owned commercial banks went down from a 19.2% in Q1 2004 to 8.2% in Q1 2007, while the capital adequacy rate went up from an average 6.7% in 2002 to a sound average of 11.4%[22] by the end of 2005. Despite the promising quantitative figures, foreign and domestic analysts remain critical about whether the stability and the quality of the banking system have really improved. "Bad loans at Chinese banks have fallen as a result of government bailouts rather than because of better governance" as stated by Tang Shuangning, deputy chairman of the China Banking Regulatory Chairman.[23]

Supporting this thesis, studies by Richard

[19] Zhang, Fengming: *City commercial banks follow the leaders on the road to the bourse*, Shanghai Daily, 11.12.2006.

[20] Deutsche Bank Research, *China's banking sector: Ripe for the next stage?*, 7 December 2007.

[21] Shanghai Daily, *Rural bank reform*, 17.10.2006.

[22] Average without Agricultural Bank of China, Material of the German Chamber of Commerce Shanghai, *Moody's Investors Presentation Materials*, June 2006.

[23] Luo, Jun: *Tighter control cut banks's bad loan*, Shanghai Daily, 05.06.2007.

Podpiera claim that "the price of credit risk remains undifferentiated and banks do not appear to take enterprise profitability into account when making lending decisions". This implies that lending decisions continue to be driven by government officials' capital requests and personal relationships rather than by commercial reasoning. This corrupt system of lending on the basis of personal relations lacks transparency and is at the root of the building up of non-performing loan. Since corruption in the P.R. China is to some extent based on a tradition of working in system of personal relations, most experts doubt that a real change of attitude has been taken place so far. That's why the risk of building up new bade loan, especially given the current annual 25%[24] increase in credit growth, is high. Accordingly, foreign banks interviewed pursue very conservative lending strategies in the P.R. China, bearing in mind the systemic risk of the building-up of new non-performing loans.

In addition, the reform of the rural financial system has only begun and needs to be deepened to include more rural financial institutions. One of the difficulties and the reason for the slow progress is the politically sensitive nature of reforms regarding property rights of rural assets.

Finally, governmental involvement in the banking sector remains important in particular with regard to the regulation of interest rates. "The authorities have been gradually deregulating lending and deposit rates, providing the banks with room to improve credit risk pricing."[25] While in 1996 there was an up and down cap on the official benchmark rate, the upper limit had been removed in 2004. Additionally, "China may scrap a 20 percent tax on interest on bank deposits to encourage savings over share speculation within this year".[26] Foreign banking professionals estimate, however, that the liberalization of interest rates will need another ten years time to take place.

*Conclusion: reforms of domestic banks*

Overall, the Chinese banking sector has improved and established the formal condition to become more efficient and commercially driven. Reforms, however, have to be expanded and include rural lending institutions. Despite the improved conditions, there remains doubt about whether a truly commercial credit culture has been established. Change of behavior regarding corruption or

[24] Ministry of Commerce of the PRC, *China moves to cool credit growth* http://english.mofcom.gov.cn/aarticle/counselorsreport/asiareport/200607/20060702697868.html, looked up on 22 August 2007.

[25] Richard Podpiera, *Progress in China's Banking Sector Reform: Has Bank Behaviour Changed?*, IMF Working Paper 06/07, 2005.

[26] Li, Yanping: *Interest tax may be scrapped to encourage domestic saving*, Shanghai Daily, 05.06.2007.

more generally speaking or an increase of transparency in the banking sector has not been acknowledged so far. Therefore, the risk of piling up new non-performing loans is big and threatens the stability of the current and future Chinese banking system.

Reforms to open the banking sector to foreign competition

Before the full opening of the banking sector to foreign competition in December 2006, the only possibility to participate in the Chinese banking retail market was indirectly through strategic investment in domestic bank. Foreign investment in domestic banks is, however, restricted to 25% and to 20% for a single foreign investor. Eventually, the opening of the banking sector to foreign competition had been set in the P. R. China's entry agreement to the World Trade Organisation in December 2001. Since then, permission has been gradually given for retail business of foreign banks in the P.R. China. With the end of the 5 year adoption phase on 11 December 2006, foreign banks were nation wide allowed to offer services in Renminbi, including taking Renminbi-denominated deposits from local citizens and issue credit cards. Foreign banks can now open 100 percent-owned subsidiaries without geographical restrictions [27]. However, overseas banks that don't incorporate locally will need three times more capital to offer Renminbi services and only take fixed deposits of more than 1 Million Renminbi.[28] "HSBC, Citibank, Bank of East Asia and Standard Chartered bank so far, won the approval to operate as local banks in Shanghai".[29] Yet capital requirement to be incorporated are as high as 1 billion Renminbi. While some other foreign banks are listed and are waiting for approval for incorporation, many foreign financial institutions, decided not to opt for incorporation due to the associated high costs. Furthermore, foreign operating banks in the P.R. China have to employ graduates for the only task to check und update regulatory guidelines on a daily basis because the regulation that frequently changes. This shows that the Chinese banking sector still benefits from considerable protection from foreign competition.

A senior manager of a foreign bank in Shanghai claims: " the door has been opened but the price of the entry ticket has been raised" in order to further protect the domestic banks. However, the opening had, of course, effect on the domestic banking

[27] Transcript of Paulson's speech in Shanghai, *Remarks by Treasury Secretary Henry M. Paulson, Jr. Shanghai on 8 March 2007*, on www.chinadaily.com.cn, looked up on 9 March 2007.

[28] Zhang, Fengming: *Overseas bank rules move forward*, *Shanghai Daily*, 10.11.2006.

[29] Zhang, Fengming: *Overseas lenders get nod to incorporate in Shanghai*, Shanghai Daily, 21.03.2007.

system.

*What effects the reforms have had on the domestic banking sector?*

Firstly, foreign competition has been a contributing factor to the restructuring and recapitalization of the domestic banking system. Secondly, Chinese employees at foreign banks have been trained in commercially orientated lending through risk management and risk control. Thirdly, service of domestic banks has considerably improved in order to successfully face foreign competition and keep domestic clients.

Therefore, in the beginning of 2007, 16 domestic banks pledged to reduce waiting times by half[30] and the maximum amount of automatic teller machines has been substantially increased so that people don't have to queue in banks for the only purpose of withdrawing cash[31]. Further new products and services are offered almost on a daily basis. The Bank of China, for example, will begin offering private banking services, becoming the first domestic bank to target the P.R. China's growing rank of millionaires in a joint project with the Royal bank of Scotland.[32] Lastly, new banking regulations are sent to foreign banks for consultancy before implementation.

*Conclusion: open the banking sector to foreign competition*

To sum up, although the P.R. China liberalized the banking sector regarding foreign competition, regulatory guidelines still control the size of exposure to foreign competition. Nevertheless the foreign influence on human capital, services and regulation have been considerable and will become more important in the future.

<u>Conclusion</u>

The Chinese government achieved major liberalization steps, one being the restructuring and recapitalization of the major state-owned banks (other banks following) while the other being the banking system opening to foreign competition. Because a truly commercial credit culture has not been established so far, the risk of piling up new loans, which threatens the stability of the banking system, is high. This lack of "commercial credit culture" is caused by the fact that the government almost completely owns (as its major shareholder) and heavily regulates the banking sector (in particular interest rates and foreign competition). Despite the government efforts to let market forces into running its banking system, it still guides the banking system mainly by macro control measures and finally allowing the banking

[30] Shanghai Daily, *Banks make pledge to cut waiting times for customers*, 17.04.2007.

[31] Zhang, Lihuo: *ATM cash limit set to soar in bank shake-up*, Shanghai Daily, 21.05.2007.

[32] Zhang, Fengming: *BOC explores private banking*, 21.03.2007.

system to remain in State control. In this sense, government control of the banking system remains the biggest obstacle in the way of becoming a sound and efficient banking system. Privatizations, deregulation of the domestic banking system and the fight against corruption and for transparency are the means to achieve it.

2.2) Reform and liberalization of the capital markets

The stock and bond markets in the PRC are highly fragmented due to capital controls, aimed at protecting the domestic financial sector.

Concerning the stock market, there are two in Mainland China (Shanghai and Shenzhen-founded in 1990 and 1991 respectively), where RMB denominated A-shares (directly available for only domestic investors) and foreign-currency denominated B-shares (available for domestic and foreign investors) are traded. Furthermore, foreign denominated H-shares of Mainland China registered companies are traded at the stock exchange of Hong Kong. H-shares might have pendants in the A-share market. The stock market price of any H-share in Hong Kong is lower than its A-share counterpart on the Mainland- again due to capital controls which undermine arbitrage effects [33] to take place. Last but not least, foreign currencies denominated Red Chips of foreign registered companies (whose holding company is on the Chinese Mainland) are restricted to foreign investors and listed at the Hong Kong Stock Exchange. The most important share market in terms of market capitalization is the A-share market, followed by the Red-Chips market, the H-share then the B-share market. After the stock market failed to become an important tool for domestic financing in the first decade reform efforts have been implemented.

Reforms in the stock market

The biggest difficulty for the development of the stock market has been the ownership structure of tradable (TS) and non-tradable shares (NTS); also referred to as split-share structure. Shareholders of non-tradable shares, meaning, directly or indirectly the government, exercise the same voting rights and bonuses as the shareholder of tradable shares. Yet, non-tradable shares cannot be bought by private persons.

*The split-share reform*

Under this two-tier system, the stock market proved to be inefficient and volatile,

[33] Arbitrage effects: arbitrage is the practice of taking advantage of a price differential between two or more markets. In the absence of capital control, trader will buy the cheaper shares on the one market und sell it on the other market and make a profit until the price differential will have disappeared. This is usually referred to as arbitrage effects.

leading most successful companies to be listed overseas, mainly in Hong Kong. After several unsuccessful trials in 1999 and 2001 to reform this system, in April of 2005, the Chinese Securities Regulatory Commission launched a last effort for reform. The end of 2006 was foreseen as a deadline for the all listed stocks. In July 2007, though not all, a remarkable portion of non tradable shares was reduced. This attempt was successful due to the fact that the compensation of the tradable-share-holders was negotiated directly between companies and floating shareholders.

*Getting a more mature and liquid stock market*

In October of 2006, the Shanghai stock exchange announced that its priority in 2007 was to involve creating a top-notch bluechip market by luring more quality listings and boosting liquidity.[34] To enhance liquidity plans to introduce securities lending[35] and a margin trading system[36] as early as this year has been drafted. Furthermore, it was discussed to widen the daily trading band[37]. Another objective includes allowing red chips to be listed in Shanghai by the end of 2007. Regarding entrepreneurs demand to risk-hedging tools to deal with growing market volatility, Shanghai stock exchange will push forward derivatives based on blue chips such as covered warrants and are working to unveil pilot stock futures.[38] Shanghai Futures Exchange is set to start zinc trading late this month, in its/her latest move to provide more hedging and arbitrage tools to domestic industries. This would be the fourth futures contract[39] in the P. R. China, after three futures contracts approved last year.[40] Trough the QDII-Qualified domestic investor scheme — which will be further explained in the following sub-section-, domestic investors are gaining limited access to foreign capital markets.

Additionally, an important move in merging A- and H-shares prices has been the very recent announcement of the Foreign Ex-

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[34] Zhang, Leo: *Stock-index fund may clear a path for bourse reforms*, 20. 10. 2006.

[35] Securities lending: owner of securities frequently lend those securities to other parties, who sell them short or deliver them to another party to satisfy some obligations. The owner receives a fee for this transaction.

[36] Margin trading is a high-risk strategy, consisting in borrowing money from a broker to purchase stocks.

[37] Zhang, Leo: *Bourse eyes widening of daily trading band*, Shanghai Daily, 13. 3. 2007.

[38] Zhang, Leo: *Stock futures on the horizon*, Shanghai Daily, 06. 03. 2007.

[39] In finance, a futures contract is a standardized contract, traded on a futures exchange, to buy or sell certain underlying instruments (shares, foreign exchange or commodities) at a certain in the future, at a specified price.

[40] Fu, Chenghao: *City future exchange gets ready to begin zinc trading*, Shanghai Daily, 14. 03. 2007.

change Regulatory Commission to allow private investors to trade Hong Kong shares directly via domestic accounts.[41]

Latest developments of the stock markets on the Chinese Mainland

After having turned many non tradable shares into tradable shares and having taken measures to cool down the real estate market, Chinese savers' money has been diverted to the stock market. Hence, the trading volume in 2007 nearly tripled the daily average of last year's. A 9 % turndown of stock values at the Shanghai stock exchange in only one day, on the 27 February 2007, raises the question how dangerous a potential future crash might be for the army of "retail investors"[42]. There is possibly political and social turmoil in this question because 50% of the investors are retail investors (compared to a 20%-30% average in developed financial markets), ranging from the cleaning worker to the average Shanghai office employee to a rich citizen. What they have in common is, generally speaking, a limited knowledge on the financial products they are buying.

This is because on the one hand the financial development is a very recent phenomena and little experience is to be found while on the other hand transparency of listed companies' business results is very low. Hence, even experienced investors have insufficient tools to make rational choices. The direct consequences consist in the absence of rational investors in the market. On top, employees quit their jobs because they are able to earn much more on stock market speculation. Or instead, they simply get fired, because of following the stock market index at work. Many companies already installed safeguard measures to prevent people from observing the stock market index during work. This implies that a potential future stock market crash would have severe social consequences. Therefore, the government decided at the end of May 2007 to cool down the stock market by raising the tax stamp from 0.1 to 0.3 per transaction to drive speculative investors out of the market. However, until now, the stock market is still growing. Foreign analysts consider the stock market to be overvalued and expect a correction of the stock market to take place in the long run.

*Conclusion: reform of the stock market*

Although improvements have been made such as the split-share reform and the development and approval of more sophisticated financial products like futures, options and warrants, there is still a long way to become

[41] Qian, Dai: *Global gateway opens for Chinese investors*, Shanghai Daily, 21.08.2007.

[42] Zhang, Leo: *China's army of retail investors make impact on markets*, 5.03.2007.

developed stock markets. After the first move towards the convergence of A-and H-share prices, the next big liberalization step will be the opening of the securities sector to foreign investors.

Especially the proportion of state-owned and state-controlled companies (44.29% of the companies of the stock markets in Shanghai and Shenzhen are State-controlled[43]) and the determinations of the State to repeatedly intervene in the stock market (the latest example being the increase in stamp tax) are a big problem. The absence of rational investors in the market is of further concern. Consequently the risk of a socially painful correction of the stock market is very likely in the long run.

<u>Reform of the bond market</u>

The bond market of the P. R. China contains government and corporate bonds. While there is a segment for corporate bonds, most of them are, however, state-owned companies. Access to the bond market for foreign investors is similarly as in the stock market restricted. The P.R. China is seeking to expand its bond market to reduce its companies' reliance on bank loans and give investors more choice.[44] Therefore, the government has eased rules and capital requirements for market makers of the country's inter-bank bond market in an attempt to bolster the debt's market liquidity[45].

*Conclusion: reform bond market*

The next big step will be the establishment of a corporate bond market, being in a second phase also available to foreign investors.

<u>Conclusion</u>

Although reforms have been undertaken, especially in the stock market, both the stock and the bond market are still more determined by state-owned or state-controlled companies and macro-control measures than by market forces. The stock market in particular bears the risk of a socially costly correction in the long run. The efficiency of both markets could be improved by privatization of listed or issuing companies, increasing accountability and transparency of listed companies and lastly the opening to foreign investors. The difficulty associated with this last step of liberalization is the rigid exchange rate, which would come under enormous pressure to appreciate, if the securities market would be opened to foreign investors. Consequently, further reforms in this sector are closely linked to the reform of the exchange rate and the capital control system.

[43] Chinese article, www.news.stockstar.com/info/daticle.aspx, 29.08.2007.

[44] Luo, Jun; Li, Yanping: "*More sense" for foreign firms to sell yuan bonds*, Shanghai Daily, 05.03.2007.

[45] Zhang, Leo: *Rules ease for makers in debt markets*, Shanghai Daily, 12.2.2007.

2.3) Reform and liberalization of monetary policy

The exchange rate is managed by the People's Bank of China, which is under the direct control of the State Council. Consequently and as laid down in its founding contract, all decisions with regard to the exchange rate and interest rates have to be approved by the government. Although the People's Republic of China has a "de jure" managed flexible exchange rate regime, it maintained a "de facto" fixed exchange rate regime and pegged the Renminbi[46] (RMB) against the US-Dollar (USD) — until very recently- at a rate of 8.3 RMB/USD. To gain some leeway for an effective monetary policy, the government protected the domestic financial system from international financial money flows through in and out-going capital controls. "China's surging trade surplus has"[47], however, "flooded the financial system with cash, fueling investment, asset bubbles and inflation at the highest rate in more than a decade".[48] This is because of the fixed exchange rate requiring the PBC to sterilize[49] its foreign currency reserves to keep the exchange rate stable. Theoretically and in the long run, the liberalization of the Renminbi and thus its appreciation is the only solution to soak up the excess liquidity in the financial system. Therefore, the People's Bank of China opted to liberalize both-the exchange rate and its capital control system.[50]

Exchange rate reform

The first big step with regard to the exchange rate has been the widening of the trading band of the Renminbi on 21 July 2005. Since then, the Renminbi has appreciated[51] more than 7% and is now calculated by the Central Bank as the central parity rate on average weighted quotes from 10 plus market makers, a mechanism that incorporates market views into the Renminbi movement. Secondly, the trading band has been widened to 0.5% on 20 June 2007 — just one day before the start of the biannual economic strategic dialogue in Washington. The move is widely seen as a merely symbolic gesture. However, officials from the Central Bank recently assured publicly that the Renminbi exchange rate will gradually

[46] The Renminbi is the official denomination of the national currency of the People's Republic of China.

[47] Piboontanasawat, Nipa: *Spending data add fuel for rate hike*, Shanghai Daily, 15.08.2007.

[48] Piboontanasawat, Nipa: *Spending data add fuel for rate hike*, Shanghai Daily, 15.08.2007.

[49] Financial sterilization is essentially a swap of international reserves for public bonds.

[50] A country can decide to either liberalize both, the exchange rate and the capital control system, at the same time or to begin to deregulate either of them.

[51] Qian, Dai: *Yuan jumps to new high against dollar*, 04.07.2007.

become more flexible.[52] A former policy advisor of the Central Bank specifies that the Government wants at least 5 years[53] of gradual steps of more appreciation before fully liberalizing the exchange rate. The opinions of Chinese and foreign experts interviewed on a fully convertible Renminbi, range from 3 to 15 years. It is assumed that even the Central Bank governors have no meticulous plan when they will eventually open up.

The question remains to whether or not the government has all the time to adjust the exchange rate in the wanted way or if economic conditions, especially with regard to inflation, will force the government to open up early. "A record trade surplus is flooding China's financial system with excess liquidity, adding to upward pressure on the yuan and threatening to push up inflation and lead to bubbles in the stock and property market."[54] The People' Bank of China announced a 5,5%[55] inflation rate in June the highest since 1997. Inflation is on the rise, mainly due to a supply shock in pork meat production caused by underinvestment and natural catastrophes. The government, however, prefers to rely on administrative measures to cope with the rising trade surplus and inflation. Although interest rates have been raised for the fourth time this year and "the central bank asked commercial banks to put aside more yuan reserves six times this year to curb lending and inflation"[56], the raises have been much too small to have any impact on the real economy. In addition, the governor of the People's Bank of China, Zhou Xiaochuan, recently stated, they will try to boost domestic demand over increasing exchange rate flexibility, as a complementary measure, the exchange rate can also play a part in the adjustment process.[57] They scrapped, for example, an export rebate tax to discourage export.

*Conclusion: exchange rate reform*

Overall, although some market instruments have been introduced into the Renminbi movement, the government largely controls the appreciation of its currency. The path to full liberalization has been set slowly and is supposed to last at least for another five years. However, the excess liquidity in the financial system due to the rising trade surplus puts the Renminbi under pressure to ap-

[52] Shanghai Daily, *Official promises yuan flexibility*, 09.07.2007.
[53] Shanghai *Daily*, *Yuan's appreciation to span next 5 years*, *analyst says*, 09.07.07.
[54] Shanghai Daily, *Yuan's appreciation to span next 5 years*, *analyst says*, 09.07.07.
[55] Zhang, Dingming; Piboontanasawat: *Bank warns that inflation may rise*, Shanghai Daily, 09.08.2007.
[56] Zhang, Fengming: *China tackles its forex flood by eliminating holding limits*, Shanghai Daily, 14. 08.07.
[57] Shanghai Daily, *Domestic demand rise key to soaring surplus*, 13.3.07.

preciate and raises fears of inflation, stock and real estate bubbles. Although in the long run, the Renminbi must become flexible to get rid of the excess liquidity in the financial system, the currently set pace of the appreciation seems adequate and inflationary pressure is considered to be due to a supply-side shock rather than caused by excess liquidity in the system. Whereas inflation seems under control, it is not completely ruled out that inflation could become a serious issue in the future.

<u>Reform on capital control</u>

Capital controls in form of foreign exchange holdings allowed to domestic residents have been eased. The amount Chinese residents are allowed to was raised from 2000 to 20,000 in March 2006 and to 50,000 USD in February 2007. For foreigners, it was reduced from an unlimited amount to the same annual quota of 50,000 USD only this February 2007.

The concrete means by which residents are investing in foreign financial products is the "Qualified Domestic Investor's Scheme (QDII)" while foreigners are investing in the P. R. China capital markets through the "Qualified Foreign Investor's Scheme (QFII)". Both schemes constitute institutional funds investing in domestic and foreign markets and are subject to approval by the Government. Furthermore, the Mainland China's first foreign exchange company opened in Shanghai as the country loosened restrictions on currency trading. Between May and November of 2006, foreign currencies brought by individuals skyrocketed 210 percent in terms of a year on year and ballooned 255 percent in terms of transactions.[58] The Chinese government is allowing companies and individuals to keep more of their foreign-currency earnings, gradually loosening capital-controls to slow growth in foreign reserves. "The government is easing curbs on the flow of money out of China to ease the pressure, while tightening controls on short-terms inflow of cash, Bloomberg News reported." [59] An important move in this direction has been the very recent announcement of the Foreign Exchange Regulatory Commission to allow private investors to trade Hong Kong shares directly via domestic accounts. The amount of foreign exchange purchases can go beyond the 50,000 USD annual limit. In addition this move should be the beginning of a major shift in merging A- and H-shares.[60]

*Conclusion: reform on capital control*

[58] Shanghai Daily, *Foreign exchange firm opens*, 28.02.2007.

[59] Shanghai Daily, *Yuans appreciation to span next 5 years a analyst says*, 09.07.2007.

[60] Qian, Dai: *Global gateway opens for Chinese investors*, *Shanghai Daily*, 21.08.2007.

Overall, the government eased capital controls in particular on outgoing capital. This is supposed to take pressure off the exchanges rate to appreciate. A full liberalization of capital controls is, however, expected to take at least 10 years time.

2.4) Conclusion reforms financial sector

The banking system might have seen the biggest part of the formal reform process while it is still lacking a commercial credit culture. The securities market, although achieving the first steps of liberalization, still has to open up to foreign investors to grow into a more liquid and rational market. Opening up to foreign investor is closely linked with what is considered to be the next big step in the reform of the whole financial sector: the liberalization of the exchange rate system. The internationalization and convertibility of the Renminbi is a sensitive issue and might take up to 5 years to be carried out. Although the three sectors of the financial system are differently advanced, they share one feature in common: public ownership and guidance through macro control measures. In order to establish a sound and efficient financial system market forces rather than macro-control measures and privatized banks, companies and an independent Central Bank rather than public ownership should run the financial system. Lastly, market forces and private ownership then have to bring a change to the composition of the financial sector which still heavily depends on the banking sector as an instrument of financial intermediation whereas mature financial markets rely more on capital markets.

## 3) Impact of financial reforms on the political system in the PRC

There are different theoretical frameworks regarding the relationship between financial reforms and democratization. Most studies focus on the impact of democratization on financial reforms. A recent paper by Sourafel Girma and Anja Short, using panel data from 26 countries from 1973-1999, shows that it is "predominately fully democratic regimes that have liberalized financial systems"[61]. Only a few studies touch the vice-versa relationship, going from international financial openness to democratization. The findings are mixed, ranging from a positive to a negative relationship. This paper aims to exam-

[61] Sourafel Girma, Anja Shortland, *The political economy of financial liberalization*, Working Paper 05/12 May 2005.

ine the impact of financial liberalization on democratization only in the P. R. China case. But how and by what means can financial liberalization lead to more political freedom in the People's Republic of China? As analyzed in section two of this paper, financial liberalization – while having seen important reform steps- is still far from being achieved. Consequently, the question about whether or not financial liberalization already had political influence is too early to ask.

Therefore, this paper aims to theoretically analyze which influence the on-going financial liberalization could have on the political future of the PRC by enlisting the driving factors of Chinese financial sector reform and specifying which of those might also be a driving factor of political reforms. The driving factors of financial sector reforms in the P. R. China can be classified into domestic and international economic and political factors.

*Firstly*, domestic political factors drive the pace of reforms [62] in the P. R. China. Although the People's Republic of China seems relatively stable, it faces severe problems such as rising income inequality between the rich coastal areas and the rural central and western areas, insufficient social safety nets, serious environmental damage and corruption. These problems cause the instability of the regime and had been witnessed by 80 000 forms of public discontent that have been only counted in 2005. Especially with regard to the rising income inequality, the Chinese Communist Party faces the dilemma to combine very different and even adverse socio-economic interests to stay in power.

The (economic) upper and middle classes, often employed with private domestic and foreign companies in the cities, are very much behind the tremendous economic progress and the legitimating of power of the Chinese Communist Party, demand quicker financial reforms. This is because on the one hand the ability of the private sector to obtain financing in particular for small and middle-size (private) businesses from domestic banks is very limited and virtually impossible. On the other hand, the investment possibilities of their savings are limited through capital controls, impeding them to buy foreign financial products, and interest rate caps on domestic bank deposits leading inflation to erode their gains on deposits. The recent developments at the Chinese stock markets are to interpret in this context. Consequently, the upper and middle class only has to gain from financial liberalization in the absence of a financial crisis.

[62] The term "pace" is used because the liberalization of the financial system in the PRC has been established as fact earlier in this paper.

In opposite, the interest of citizens in less developed cities or rural areas or employed by state-owned or controlled companies favor rather slower reform of the financial system. This is because firstly the citizen of these areas benefit from financial resources channeled to development projects by state-owned bank, which most probably would not have been financed by commercially orientated and fully privatized banks. Quoting Mr Huang "80% of the municipality growth of Chongqing in Central China in the past decade has come from investment (half financed by state-owned banks and the government)".[63]

Secondly, employees with state-owned or controlled companies, after all 29%[64] of the working population, are able to keep their job because they are financed by state-owned (or controlled) banks, although their bad results wouldn't allow for any financing from commercially orientated banks. Lastly, the full liberalization of the exchange rate, would imply [65] the appreciation of the Renminbi, and deliberately hurt export companies. This would cause unemployment in the export sector, which is mostly situated in the central Provinces, already less well off than the rich coastal areas. Currently, there are indices that exporters with low margins are already hurt by the appreciation. Yet, only a small proportion of the exporters are concerned, according to survey conducted recently by the government.[66] The conducted survey demonstrates the importance the government attachs to the influence of the currency appreciation on the export capacities. These socio-economic groups will not benefit from financial liberalization in the short run.

Accordingly, the Party has to find the right balance or pace of reforms to satisfy both adverse socio-economic interests, which unsatisfied, bear the risk of civic discontent and could possibly undermine the Party's grip on power. Therefore the Chinese Communist Party controls for financial sector liberalization and its pace. A vividly example of this final control on reform is the answer of one of my interviewees about whether or not Shanghai will be the new financial center in Mainland China: "if market forces apply, Shanghai will, of course, become the new financial center, but if the government decides otherwise, Beijing could become the new financial center in Mainland China".

[63] The Economist, China's Chicago, 28.07.2007.

[64] Figure as of 2005, National Bureau of Statistics of China, *Employment Statistics*, www.stats.gov.cn, looked up on 29.08.2007.

[65] Due to the growing trade surplus, the liberalization of the Renminbi would currently lead to its appreciation.

[66] Shanghai Daily, *Exporters unfazed by yuan's climb*, 02.03.2007.

Thus, the government slowly reforms the financial sector in order to meet the demands of the urban economic upper and middle class, while still being able to channel financial resources to the less developed areas to guarantee and develop employment and improve living conditions.

The different socio-economic interests lead to different interests and opinion about the pace and means of financial sector reform in the Chinese Communist Party itself. Province Governors (Party chiefs) of developed and often service based Provinces or Municipalities such as Shanghai have different opinions and interests in financial liberalization than have officials of agricultural or less developed Provinces. The most recent example for this conflict of interest within the Chinese Communist Party is the fall of former Shanghai Party Chief Chen Liangyu in September 2006, who was not only dismissed from the Party and all his posts but also faced criminal charges over a social security scandal involving the embezzlement of 230 Million Renminbi. Although his guilt has been proven, his prosecution is assumed to have been politically motivated.

He belonged ideologically to the liberal reformer group of former President Jiang Zemin and former Premier Zhu Rongji as opposed to President Hu Jintao and Prime Minister Wen Jiabao, who, while supporting liberal reforms, constantly underline the importance of a harmonious society. In practice, President "Hu has focused economic policy on shifting resources to the country's poorer interior and promoting what he calls a "scientific development concept", which described as an attempt to balance economic growth with concerns about the environment, the welfare of rural farmers and workers, and a widening income gap."[67] In this respect, the fall and prosecution of Chen Liangyu can be interpreted as a demonstration of power from the "harmonious society" concerned "Beijing clique" of President Hu Jintao against the economically liberal reformer of Jiang Zemin. For financial sector reforms, this implies that the pace of financial sector liberalization will be as slow as to assure the development of the "poorer interior", even to the detriment of more advanced Provinces and Municipalities.

Overall, financial liberalization advances very slowly because the central government needs the control of the financial system to serve adverse socio-economic interest in order to stay in power. If in the short run – in case of a crisis- or in the long run – for purely economic or financial reasons, the government needs an efficient government, it would have to cease control over the finan-

[67] Washington Post Foreign Service, *Hu tightens party's grip on power*, 24. 04. 2005.

cial system and consequently would have lost — to some extent- the ability to serve different socio-economic interests.

While much depends on a country's willingness to liberalize its financial sector (determined by its political interests to do so), certain conditions for financial liberalization, such as the respect for the rule of law, secure property rights, low level of corruption and competent and effective prudential regulation and supervision, are results of a broader range of measures including constitutional structures, laws, regulations and their enforcements and are – under certain constitutional premises- sometimes even beyond a direct Government influence. In the P. R. China this involves the fact that Provinces are not implementing or enforcing the laws and regulations of the Central Government.

This paper focuses among these conditions on the absence of transparency and associated with it corruption. Transparency International, a NGO, operationally defines corruption as the misuse of entrusted power for private gain."[68] Transparency, by contrast, is defined as a principle that allows those affected by administrative decisions, business transactions or charitable work to not only knows the basic facts and figures but also the mechanisms and processes. It is a duty of civil servants, managers and trustees to act visibly, predictably and understandably."[69]

Consequently, the term corruption in this paper does not only refer to bribery, but is extended to personal favors beyond commercial reasoning or meritocracy.

Transparency International, an international non governmental organization aimed at fighting corruption, classifies countries according to their residents' perception of corruption. The P.R. China was classified 70th out of 163, the first rank being attributed to the country with the lowest corruption perception. Chinese citizens indeed consider their government officials corrupt and their decision not transparent. Quoting one of my interviewee, "government officials have the power to buy anything", while describing how a commercial bank in an Eastern Chinese Province was forced to lend money to the son of former President Jiang Zemin. In particular, this form of corruption involving lending of domestic bank officials to customers because of their social status (Party member or officials) or their personal relationship bear the risk of building up non-performing loans, thereby threatening the stability of the banking sector. As corrupt be-

[68] Transparency International, FQA about corruption, www. transparency. org, looked up on 10 August 2007.

[69] Transparency International, FQA about corruption, www. transparency. org, looked up on 10 August 2007.

havior in China is to some extent based on the tradition of working in system of personal relations most experts doubt that a fix quick to the problem is possible.

A low level of corruption, however, plays a considerable role in the financial sector. This is because the financial sector involves non tangible assets and benefits in the future, transparency and the absence of corruption is essential, even more than in other economic sectors.[70] The central government though realized the seriousness of the corruption problem and tries to improve legislation regarding corruption and its enforcement. Only recently anti-corruption legislation has been updated to include stock market shares in the list of inappropriate gifts to accept for officials.

As far as the enforcement of anti-corruption legislation is concerned, the newspapers report about detained officials for charges of corruption on a daily basis. Nevertheless, foreign analysts assume that the extent of corruption is still much higher and the prosecution of the respective officials mostly serves secondary objectives, too. Additionally, the power of the central government is often over estimated, in particular outside of China. Thus despite the determination of the central government to fight corruption its means to achieve its objective are limited. In theory, specific anti-corruption legislation and its enforcement, elections and free press are the means to establish a transparent and corrupt free society. Because in the P.R. China case enforcement surpasses the capacities of the central government and corruption is additionally culturally facilitated, only an effective check and balance mechanism such as a freer press or more direct election would, in my opinion, enable the government to fight corruption. Singapore is often cited as a counter-example providing a business environment of low corruption with a censured press and a one-Party rule.

In a country of 4.5 million people, however, anti-corruption legislation and its enforcement seem to work. In the PRC with its 1.3 billion people it does not.

Consequently, if the government is serious to fight corruption and establish a sound financial system, it has to cease political control in the form of a check and balance mechanism such as a freer press or more direct election.

*Secondly*, <u>international political factors determine the financial liberalization process in the P.R. China.</u> International economic organizations and in particular international financial organization (like the International

[70] That is why one won't find a banker without tie. Indeed when the financial industry developed in the 19th Century, bankers introduced the suit as work clothes to inspire trust with their customers.

Monetary Fund) are able to speed up a country's financial liberalization policy. So do the G8 or bilateral channels, for example, the strategic economic dialogue between PRC and the United States. In the P.R. China case, especially the entry to the World Trade Organisation had an effect on the financial sector liberalization. Hence, reform of the state-owned banks has been speed up to be ready for the banking system openness to foreign competition. Also, soft effects like improvement in service quality to clients, increased banking management knowledge and regulation have been noticed. International pressure (in particular by the United States) to liberalize the Renminbi exchange rate had, if any, symbolic influence. Given that the People's Bank of China has the highest foreign currency reserves (1.33 trillion USD) in the world and need neither a loan from the IMF nor from any other foreign financial resources, the international community has no real leverage besides moral persuasion for the Renminbi liberalization cause.

One of the reasons for the central government to accumulating these reserves is precisely the fear of a financial crisis followed by a rescue program of the International Monetary and the international community, which — as the Asian financial crisis of 1997 has shown — puts the domestic economy under foreign control and subject to foreign accountability. This foreign intervention in their economy is what the Chinese Government wants to avoid at any price. To summarize, the foreign political influence, playing a role though — especially in the banking sector-, is rather limited in the process of liberalization of the financial sector in particular with regard to the exchange rate liberalization. Since the foreign influence on the financial liberalization is limited, the question on its political influence becomes superfluous except for one smaller argument. If a liberalized and appreciated Renminbi will have become reality one day, citizen's abilities to travel or study abroad will be increased. In a survey of the "Shanghai Daily"[71], most interviewees associated with the appreciation the significance of the Renminbi increased personal possibilities to travel abroad. This could potentially cause more awareness on certain sensitive issues such as an authoritarian governance style and human rights protection.

Thirdly, domestic economic factors determine the pace of the financial system liberalization in the People's Republic of China. "Once the economic distortions imposed by

[71] Shanghai Daily, *With the value of the yuan surpassing the Hong Kong dollar for the first time in 13 years, do you have any new plans to travel or spend abroad*, February 2007.

financial repression undermine economic performance we may observe financial liberalization for example as a policy response"[72] to an overheating economy. Increasing liquidity caused by the growing trade surplus ("the seven-month surplus in 2007 will be USD 135.6 billion, up almost 80 percent from a year earlier"[73]) and investment puts the Chinese economy under the pressure of overheating and inflation. As the theory of the impossible trilogy suggests, "only two of the three following features are mutually compatible: full capital mobility, independence of monetary policy, and a fixed exchange rate"[74]. Given the "de facto" fixed exchange rate and capital controls, that can be circumvented though, the Chinese government is not fully enabled to pursue an independent monetary policy. Yet, an independent monetary policy allows the Central Bank to uses it most powerful tool to cool down the economy: the interest rate. As described in section 2.3, the Chinese government currently seems to control the risk of overheating and inflation through macro-control measures such as discouraging export and credit growth to dry up the cash flood in the financial system.

Nevertheless, if in the near future the pressure on the Renminbi in the form of inflation inflicted on the domestic economy becomes too high, this could lead to the liberalization of the Renminbi and the financial system in the short run. In the long run, the increasingly sophisticated Chinese economy will require an efficient and sound financial system with a free floating Renminbi exchange rate, important capital markets and a truly commercially orientated banking system. Hong Kong, as international financial place, is might able to postpone the necessity of a commercially sound financial system in Mainland China.

The liberalization of the exchange rate, be it in the short or the long run, will require an independent central bank, which without the high amount of foreign reserves inert to a fixed exchange regime won't be able to easily bail-out the from non-performing ailing domestic banking sector. Hence, the domestic banking sector would have to undergo serious reforms regarding commercially lending practices. Depending whether or not the floating of the Renminbi will go hand in hand with the removal of capital controls, foreign investors would push and control for transparency and improved financial regulation.

[72] Sourafel Girma, Anja Shortland, *The political economy of financial liberalization*, p. 9, Working Paper 05/12 May 2005.

[73] Piboontanasawat, Nipa: *China's July trade gap may have jumped 60%*, Shanghai Daily, 10.08.2007.

[74] A. S. Fatemi, *Le meridian montparnasse*, 26.03.1998.

To sum up, for purely domestic economic reason the Chinese economy will require, in the short term if inflationary pressure transform into a crisis or in any case in the long term, an efficient and sound financial system.

Hong Kong might be a help to postpone necessary reforms. In the People's Republic of China the liberalization of the exchange rate will have a positive impact on the reforms of the overall financial system.

*Fourthly*, <u>international economic factors potentially dictate the pace of financial liberalization process in the People's Republic of China.</u> A country's openness to trade potentially puts additional pressure on the currency because it allows circumventing capital controls via under- and overwriting of trade bills. Given the expectation of a Renminbi appreciation, much speculative money flow into the Mainland China in this way. This, in turn, increases the pressure on the Renminbi liberalization. If the P.R. China wants to become an international financial center, it would have to substantially improve the rule of law and the access to information for its residents. Furthermore, international financial institutions often exercise considerable power and influence on companies and government actions. Since Hong Kong functions as international capital market, the P.R. China won't be in need of an international financial center on the Mainland in the short run.

## Conclusion

Financial liberalization in the P.R. China can be considered a factor of further political liberalization depending on if and when the Chinese Government needs an efficient and sound financial system on the Mainland China. While reforms have been successfully implemented, government intervention in the form of state-ownership and control, regulation and corruption are the main impediments to the establishment of a sound commercially orientated financial system. Indeed, the government slowly admits market forces but still remains in final control of the financial system and its pace of reforms. This is because the government has to remain in control of the financial system to serve different and adverse socio-economic interests in order to guarantee its grip on power. Consequently, if one day the government will be in need of an efficient financial system, it has to cease control over the financial system and will, thus, loose — to some important extent- the ability to serve different socio-economic interests. This, in turn, could trigger social unrest, possibly involving a substantial loss of power of the

Chinese Communist Party. The establishment of an efficient and developed financial system would additionally require the Chinese Communist Party to actually fight corruption, which in the given context seems only enforceable through political concessions in the form of freer press and/or more direct elections. Furthermore, the Chinese economy will require either in the short or the long run an efficient and sound financial system. In the short-run scenario, involving financial liberalization caused by very high inflation or a financial crisis, the Chinese Communist Party would probably have to cease more power than in the long-run scenario. Simply because in the long run socio-economic interests will supposedly be more converged and thus, the loss of control over financial resources is politically less dangerous for the Chinese Communist Party. In the long-run, an efficient financial system needs to support the increasingly sophisticated and upgrading Chinese economy. Hong Kong as international financial center will most likely help to postpone the timing of its implementation. Currently, the risk of overheating and inflation seems under control. Accordingly, the long-run scenario seems more likely to happen. An international or national crisis, however, involving or not the use of force could change all the settings on which the arguments of this paper are based. Overall, financial liberalization can be considered a factor of political liberalization in the People's Republic of China depending on the timing and the circumstances of the former taking place and the respective policy responses of the Chinese Communist Party to a national or international crisis.

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