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Access to Capital in China: Competitive Conditions for Foreign and Domestic Firms

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Introduction

The Chinese financial sector is illustrative of the hierarchy of privilege that has dominated the country's transition from a centrally planned economy to a more market-based system. Despite their declining contribution to GDP, large state-owned enterprises (SOEs) sit at the pinnacle of financial access. They obtain a disproportionate share of financing from all sources: bank loans, stock markets, venture capital, and bond markets. Because large, inefficient SOEs get most of the canalized capital, and because they are still required to provide many of the social services for their employees and families, there is a substantial bad-debt problem in the system that is unhealthy to let continue but dangerous to unravel. Private firms, domestic and foreign, which in the last five years have played a critical role in China's growth, face substantial capital access barriers and must use a wide variety of informal means to obtain access to capital and pay more for it. Greater access to capital for these firms, and the full implementation of international standards of lending and market regulation, would fuel China's fastest growing enterprises and precipitate greater domestic competition.

The December 2006 deadline for China's WTO commitments in the financial sector will bring increased foreign participation in Chinese banks and foreign competition that will limit the government's ability to continue lending to loss-making SOEs. China reportedly channels most financing to its large SOEs because of the perception that they are too important – from the standpoint of employment and social stability – to fail. However, redirecting more bank,

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equity, venture capital and debt financing from SOEs to private enterprises could increase the efficiency of investment and significantly improve returns for the large number of households who hold their savings in bank deposits. This article begins with a description of the banking, equity, venture capital and debt sectors of China's financial system, considering both historical information and recent trends. It then addresses the competitive conditions facing foreign firms, focusing on regulatory barriers as well as practical impediments to participation in these sectors.

The Banking Sector

Overall Structure

The banking system is the dominant player in China's financial sector. Most credit is extended through bank loans, which represented 78 percent of funds raised by households, enterprises and government sectors in 2005, followed by government bonds, corporate bonds and the stock market (table 1).

Table 1 Funds Raised in China's Domestic Economy, 2001-2005 (as percent of total)

Items	2001	2002	2003	2004	2005
Bank loans	75.9	80.2	85.2	82.9	78.1
Government bonds	15.7	14.4	10.0	10.8	9.5
Corporate bonds	.9	1.4	1.0	1.1	6.4
Stocks	7.6	4.0	3.9	5.2	6.0

Source: People's Bank of China, 2002-2006.

Historically, banks have been the government's primary tool for achieving industrial goals. In the 1960s and 1970s, bank lending complemented the government's production plans, with banks acting as "cashiers" for the economic program (Huang, Saich and Steinfeld 2005, 2). Bank managers, appointed by government officials, provided financing to SOEs based on national development plans. Until 1979, the People's Bank of China (PBOC) was the only bank in the country, acting both as the central bank and the source and location for most bank loans and deposits (Lardy 1998, 61).

The banking system gradually evolved in the 1980s, with the establishment of the "Big Four" state-owned commercial banks (SOCBs) and other large state-owned banks, to take over the lending functions of the PBOC. Policy lending – that is, lending directed by central or local governmental authorities rather than based on commercial principles – predominated in the Big Four in the 1980s and early 1990s. The SOCBs financed large SOEs that had little interest or ability to make repayments, particularly since they also were required to provide costly public services (Green 2004, 5).

To address losses from policy lending, the government attempted to remove this function from the SOCBs, establishing three policy lending banks in 1994. Joint stock commercial banks, city banks, and rural and urban credit cooperatives, all directly or indirectly government-owned, also were set up to diversify the financial system and to finance development projects.

The four SOCBs, however, remain the dominant players and the principal lenders to the SOEs. SOEs are the favored customers of the SOCBs and policy lending banks, which control a disproportionately large share of the banking assets. The policy banks are expected to fund infrastructure and development projects and lend predominantly to the SOEs. The equity of the joint stock banks is partly owned by the state and partly by other interests, such as SOEs and private enterprises. Although China has two nominally private banks, both are dominated by state shareholders and management (EIU 2006d, 21-2). Foreign banks play a very small role in the market (table 2).

Table 2 China's Major Banking Institutions, Number of Institutions, Share of Total Assets and Share of Total Loans, December 31, 2005

	Number of Institutions	Share of total assets	Share of Total Loans
Big Four Banks	4	53.5	50.5
Joint Stock Commercial ..... Banks	13	15.3	15.4
City Commercial Banks	115	5.4	5.2
Urban Credit Cooperatives ...	681	.5	.5
Rural Credit Cooperatives	32,876	8.3	8.9
Policy banks and other .... institutions (finance, trust and investment and leasing companies)	149	15.4	16.8
Foreign Banks (parents, ... subsidiaries and branches)	278	1.6	1.6

Source: ICBC 2006, 41.

Policy lending, and the high degree of state ownership of China's banking institutions, result in a banking system focused on the financing needs of large SOEs, to the detriment of domestic and foreign private firms and individuals. Small and medium-sizes enterprises (SMEs), which produce more than half of gross domestic product, obtain only about 10 percent of bank loans. Over 90 percent of private firms surveyed in a joint OECD-China National Bureau of Statistics study stated that they had difficulty accessing bank credit (OECD 2005, 142). Because of limited access to bank loans, SMEs must depend on personal financing, retained earnings and informal markets to raise capital (box 1).

Box 1 China's Shadow Financial Markets

A study by China's Central University of Finance & Economics estimated that an amount equal to approximately 30 percent of all official loans was borrowed in informal markets in 2003.

- Informal markets are particularly critical in rural areas. In some of the least developed western provinces of China, 60-70 percent of financing for SMEs comes from informal markets, while in coastal areas the share may reach 30 percent.
- Interest rates are much higher on the informal markets. While the interest rate set by the Central Bank on short and medium term loans is low (less than 6 percent), interest rates in informal markets in Jiangsu and Zhejiang range from 12 to 30 percent; in the northeast and northwest, annual rates of 100 to 200 percent are not unusual.
- Informal lending can take many forms, including individual lenders, enterprise networks, pawnshops and underground financial organizations. Some firms tap the funds of large SOEs by selling a portion of their company to the SOE in exchange for a credit guarantee that enables the firm to borrow from banks. However, finding an SOE willing to provide a credit guarantee can be difficult and expensive.
- For those firms without access to credit guarantors, murkier arrangements may come into play. Related party transactions – for example, where the firm sets up and capitalizes a subsidiary and then uses the subsidiary as a loan guarantor without disclosing the relationship – create off-the-books risk for lenders.
- Receivables financing – where firms borrow against the strength of their accounts receivable – can be convoluted. One variant is for a firm to arrange a fake transaction with a related party and then use the fake invoice as collateral to borrow from an SOE. The SOE may obtain a pledge of assets as fixed security and enjoy the advantage of a better return than it can obtain from its bank deposits – assuming the loan is repaid. If not, there is little recourse.

Source: Xiaojie and Jian 2005.

This large amount of informal lending adds substantial off-the-books risk to an already unstable financial sector. However, complete suppression of the in formal markets would cut off a critical funding source for firms. Removing barriers to access to capital in the formal system is essential to reducing demand in the shadow markets. The ability of a financial system to provide funds to the private sector, rather than just making loans for political reasons, is strongly associated with economic growth (Lardy 1998, 130).

The large number of non-performing loans (NPLs) that policy lending produces has been a drag on China's domestic economy. The total amount of NPLs is substantial; official estimates of $164 billion are dwarfed by private estimates that go as high as $800 billion (although Ernst & Young recently withdrew its estimate of $911 billion) (Schmitt and Feiger 2006). According to the PBOC, the NPL ratio for the Big Four banks was 9.8 percent in March 2006, but the official press regularly notes that 30 to 40 percent of loans are not recoverable and some estimates go as high as 60 percent (EIU 2006d, 19). Much of the difference in estimates is attributable to the treatment of new loans made during a lending spree from 2002 to 2004 (EIU 2006c; Bottelier 2005). Figuring out whether these new loans are markedly better than the old is critical, particularly since there was another large surge in lending in the first half of 2006. The government has expressed concerns; in 2005, the PBOC estimated that companies with outstanding debts of nearly $23 billion, almost all owed to the Big Four banks, would go bankrupt by 2008 – these future debts are likely to be a continued drag on the banking sector (EIU 2006e).

Increased reliance on commercial lending standards, rather than policy lending, would go a long way toward improving overall loan quality and access to capital for private firms. Unfortunately, a recent IMF working paper found little evidence that SOCBs have become more commercially-oriented. The pricing of credit risk remains undifferentiated; lending appears to be driven primarily by the availability of deposits; and banks do not appear to take a firm's profitability into account when making loans (Podpiera 2006, 18). The Chinese Banking and Regulatory Commission (CBRC) similarly has reported that it is "common practice" for banks to ignore regulations and fail to monitor loans and that bad loans levels are "not accurately revealed" (EIU 2005b). These practices would be difficult to maintain in a more open banking sector.

Conditions of Competition For Foreign Firms

Competitive Conditions for Foreign Banks

China's preparations for entry, and entry into the WTO in 2001, have been crucial drivers of the incremental reform and development of the financial sector. China is expected to comply at the end of 2006 with its WTO commitment to lift all geographic limitations and restrictions on the type of business foreign banks may conduct; at that time, foreign banks should be able to enter the market and service Chinese companies and individuals on a national treatment basis (Garcia-Herrero and Santabarbara 2004, 22).

As required by its WTO commitments, China has been relaxing restrictions on foreign banks, albeit gradually. In 2001, China opened up banking services in foreign currency to all banks. Since 2003, foreign banks have been authorized to conduct some operations in the wholesale domestic currency market, but with geographic limits; foreign banks may offer loans and accept deposits in foreign currency, and provide yuan-denominated services to businesses in 25 cities (Carew 2006). In September of 2004, China lifted a rule limiting foreign banks to opening a single branch per year, a significant barrier to competition. China has announced that new rules governing foreign banks will take effect on December 11, 2006, the anniversary of its WTO entry. Draft rules indicate that China may require that foreign banks incorporate each local operation as a Chinese company with a substantial amount of registered capital, and may impose a high minimum for the deposits that foreign banks may accept from individuals. They also require that foreign banks have a history of profitable operations in China. A high threshold for individual deposits, and a prohibition on domestic currency loans to Chinese individuals, will keep the majority of personal transactions out of the reach of foreign banks (Morgan 2006).

As China has lifted banking restrictions only gradually, foreign banks have not substantially increased their participation in the banking sector. Foreign banks' share of the market has remained basically unchanged since the 2001 accession; they continue to source less than one percent of RMB-denominated loans. Only participation in foreign exchange loans has shown marked improvement (table 3).

Table 3 Foreign Banks' Participation in Market Share, RMB Loans and Foreign Exchange Loans, 2001 and 2005 (percent)

Measure	2001	2005
Market share	1.8	1.9
RMB loans	.35	.55
Foreign exchange loans	15	21

Source: PBOC 2006b, 4.

The limited participation of foreign banks in the financial sector also is attributable to China's erection of additional regulatory barriers to competition. Thus, in 2002, China imposed working capital requirements that are substantially higher than international standards; more than 15 times higher than those required in the European Union, for example. The requirement that banks wishing to carry out RMB business must have operated in China for three years with two fiscal years of profitability also is a significant barrier to entry (EIU 2004, 70). Similarly, China's 20 percent limit on the equity that a single foreign investor may hold in a bank and 25 percent limit on the equity of all foreign investors – restrictions that are asserted to be inconsistent with China's WTO commitments – have impeded participation in the banking sector (USTR 2005, 77). Foreign bank representatives overwhelmingly identify the complex regulatory environment as the most difficult aspect of the Chinese banking industry (Pricewaterhouse Coopers 2005, 19).

The government has been receptive to minority participation by foreign investors in Chinese banks. This "corporatization" (as opposed to privatization) of the SOCBs moves the government from sole owner to a shared, but still majority, ownership position. Currently, Newbridge Capital, a U.S. non-bank investor that holds 17.9 percent of Shenzehn Development Bank, is the only foreign investor with a controlling interest in a domestically-registered bank (Federal Reserve Bank of San Francisco 2005). By the end of 2005, foreign financial institutions had taken stakes in 20 different Chinese banks (McLaughlin 2006). Many of these minority investments come with competitive restrictions. Thus, for example, as part of its China Construction Bank (CCB) investment, Bank of America agreed to close existing retail operations, not open new ones and to lock up its CCB shares for three years (Carew 2006).

The greatest foreign investment focus has been on the Big Four SOCBs, which together account for more than 50 percent of the assets of the banking system. IPOs for three of the Big Four SOCBs have been completed. Prior to the IPOs, the balance sheets of the SOCBs were cleaned up by transferring the bulk of NPLs to asset management companies which issued bonds for the loans' full face value, despite the limited ability to collect on the bad loans. The October 2006 IPO for China's largest bank, the Industrial and Commercial Bank (ICB), which raised more than $22 billion (the world's biggest IPO ever), was preceded by the transfer of about $85 billion in bad loans to an asset management company, a $15 billion infusion from an investment arm of the government, and the $3.8 billion sale of a 5.8 percent stake to a foreign group. And these were not the first cash infusions; a large number of NPLs were removed from the books in 1999, when ICB's NPL ratio stood at 47.5 percent of all loans. ICB reported an NPL rate of 4.1 percent just prior to the IPO (EIU 2006e).

These equity stakes permit foreign institutions a greater exposure to retail banking and access to branch networks that can facilitate the cross-selling of credits cards, insurance and mutual funds to individual consumers in the large domestic market (OECD 2005, 151-52). However, foreign investors' ability to improve corporate governance is limited by their minority stakes and competitive restrictions. China's guiding principles entitled "long stake holding, governance improving, business cooperation and avoiding peer competition" make clear its intent that foreign investors become strategic partners rather than competitors as the banking sector is opened (PBOC 2006a, 4). The success of this strategy for foreign investors remains to be seen.

Competitive Conditions for Foreign Invested Enterprises (FIEs)

FIEs have limited access to capital in China. Most FIEs depend on parent company financing and the reinvestment of profits earned locally. It is very difficult, however, for smaller FIEs to obtain funds without ties to local bank managers or loan officers. Foreign banks, the most reliable source of local funding, can raise only limited amounts of capital (EIU 2006d, 5,124).

The restrictive foreign exchange control system further complicates FIEs access to capital. The State Administration of Foreign Exchange (SAFE) is responsible for administering the complex regulations China employs to maintain currency transactions that are generally open on the current account but closed on the capital account (box 2).

Surveys of FIEs confirm the difficulties posed by the foreign exchange control system and limited access to local capital. FIEs identify financial and tax issues, and particularly the regulation of capital and earnings, as one of the greatest challenge of investing in China. They also cite difficulties in obtaining loans and banking services that are inadequate to meet demand (Pricewaterhouse Coopers 2004, 6-7). The latter complaints are similar to those articulated by domestic firms as well (Tam 2005, 66). Off-shore sources of finance often are critical to FIEs; foreign exchange controls and a complicated regulatory environment substantially undercut their access to capital.

Box 2 FIE Foreign Exchange Transactions in China

- FIEs must first obtain permission from SAFE to open and maintain foreign exchange accounts for current and capital account transactions.
- There are three types of accounts that a foreign investor is permitted to open prior to establishing an FIE: expense accounts; acquisition accounts; and guarantee accounts that can be used for initial expenses. These accounts may be transferred to the FIE's capital account once the FIE is established.
- Once established, and after obtaining the necessary registrations and licenses, the FIE must set up separate accounts for current and capital account transactions. To maintain control over foreign exchange in the current account, authorities fix a ceiling on the account when it is opened. Funds that exceed the ceiling must be converted to RMB. For capital account transactions, FIEs must obtain SAFE permission. Different rules apply based on whether the transaction involves inward remittance, settlement, sale or payment of foreign exchange.
- FIEs are limited in the total amount of foreign debt they may carry to the difference between the total investment and the registered capital. For short-term foreign exchange debts (under a year), only the outstanding amount of debt applies towards the total permitted. Medium and long-term debts permanently eat into the permitted amount, regardless of repayment. Beginning in April of 2005, this limit also applies to RMB-denominated loans.
- Chinese law also requires FIEs to hire Chinese registered accountants to prepare an "investment verification report" to ensure that capital contributions and other transactions are carried out in compliance with the requirements of the foreign exchange authorities.

Source: American Chamber of Commerce People's Republic of China 2003.

The Stock Market

Overall Structure

Like the banking sector, the stock market in China was mainly established as a funding source for the large SOEs. The Shanghai and Shenzhen stock exchanges, which listed their first shares in December of 1990, were controlled initially by their local governments. The local governments enjoyed substantial de facto powers to develop and regulate the markets and local government leaders selected the SOEs that would restructure and list on them. Companies under local government control that were socially or economically important, or in dire need of capital, received preference, to the detriment of those without powerful connections (Green 2003, 40, 65). With little or no interest paid on bank savings accounts, China's savers initially were motivated to invest in the stock markets by artificially high listing profits and the misconception that investments would be protected because the markets were set up by the government. More recently, poor investment opportunities and returns, non-transparent and unreliable company records, and a wave of corruption scandals have contributed to declines in the stock market, even while China has enjoyed record GDP growth (Livett 2005, 13).

Beginning in the 1990's, the China Securities and Regulatory Commission (CSRC), under the direction of the State Council, incrementally obtained authority over the stock exchanges from local entities, with the goal of bringing them up to international standards (Green 2003, 137-56). However, the CSRC struggles with two conflicting mandates: promotion and regulation of the market (Wang 2004, 54). As a government agency, it is required to implement the government's industrial policy, that is, supporting the SOEs and ensuring they have access to capital through the stock markets. Thus, for example, in 1997, the CSRC required as a necessary condition for a public listing and priority access to IPOs that an SOE have merged with or taken over a loss-making SOE. This requirement was intended to advance the governmental goal of tou-kun – "shaking off the difficulties" of the failing enterprises (Zhang 2005, 34, 36). By contrast, listing procedures adopted in the last few years are more market-oriented and consistent with the CSRC's regulatory agenda.

The stock markets also have been hindered by governmental decisions to restructure the SOEs for public listing in a manner that still preserves state control. Shares typically have been divided into three types: state shares; institutional shares (also known as legal person or LP shares); and individual shares. State shares are held by central and local government agencies and LP shares are held by profit-seeking SOEs or other state-controlled institutions. LP and state shares, which together represent about two thirds of all shares, cannot be traded publicly; they can only be transferred, upon approval of the stock exchange (LP shares) or the Ministry of Finance (state shares). The final third of the shares, individual shares, are the only type that can be traded on the exchanges. Individual shares may be one of three types: A-shares, initially available only to Chinese retail and institutional investors; B-shares, available only to foreigners until 2001, when they were opened to Chinese retail investors; and H-shares, issued abroad by Chinese corporations for foreign investors, usually in Hong Kong but also New York and London. This restructuring method has created firms that are "one-third privatized" and that suffer from flawed corporate governance structures and the inadequate performance incentives that arise from ongoing governmental control (Green 2004, 2, 3).

Consistent with the focus on financing the SOEs, the stock exchanges have provided few listing opportunities for private firms. In 2001, 81.6 percent of listed firms were controlled, directly or indirectly, by the state. Only 18.4 percent were controlled by the non-state sector, specifically, domestic private firms, collectives and foreign private firms. Listings for foreign private firms were particularly small, less than one percent of the total (Liu and Pei 2005, 120-21).

In addition to their dominance of domestic stock markets, large SOEs also have been favored with preferred access to overseas markets. In 2005, mostly large SOEs raised $24.7 billion from H-share issuance overseas (Pricewaterhouse Coopers 2006, 3). Domestically, they raised an additional $19.2 billion from the issuance of non-tradeable state and LP shares, compared to only $4.2 billion from the issuance of tradeable shares (Chinese News Digest 2006).

The CSRC has taken steps to address distortions in the stock markets including a pilot program in 2005 to begin conversion of the state's non-tradeable holdings to tradeable shares; measures to end divisions between A-shares and B-shares; the establishment of a Board for SMEs in the Shenzhen stock exchange; and measures to implement a more objective system for new listings (EIU 2006a, 51). The CSRC suspended all new IPOs on China's stock markets in April of 2005, while the program to sell-off state shares was being implemented. By January 2006, 458 listed companies had completed or were in process of selling off some of their state shares and in June 2006, the CSRC permitted the resumption of domestic IPOs (EIU 2006d, 102-3). Whether reforms to unify the A- and B-share markets and convert non-tradeable shares to tradeable will continue, while China still maintains the controls on the capital account that are intended to insulate the country from global financial market swings, remains to be seen.

Competitive Conditions for Foreign Firms and Foreign Investors

FIEs in China are largely unable to access stock markets to sell equity. The stock markets are focused on facilitating the restructuring and injection of capital into the SOEs, not on the financing needs of domestic or foreign private firms. These barriers to capital access are substantial and are not addressed in China's WTO commitments (USTR 2006, 153). Although China announced that foreign firms would be permitted to list on domestic exchanges, in the wake of its entry into the WTO, the reality has been to the contrary. Permitting international companies with substantial China operations to offer A-shares on China's stock markets would provide the companies with a domestic avenue to raise capital, and improve the quality and diversity of China's stock markets (EIU 2006d, 111).

More positively, China has expanded opportunities for established foreign investors to participate in its stock market. In 2002, the CSRC began a qualified foreign institutional investor (QFII) program to provide more investment opportunities for foreign asset management companies and capital injections for listed companies. The QFII allows qualified foreign investors to invest in A-shares of stocks, bonds, and funds approved by the CSRC. At the end of 2005, there were 26 QFIIs with an approved investment quota of $4.05 billion, with the quota set to be raised to $10 billion in 2006 (EIU 2005a). Recently, China announced additional rule changes to further facilitate foreign investment in Chinese-listed companies. Since the end of January, 2006, foreign investors have been able to buy A-shares directly on China's stock markets, rather than through asset management companies. The foreign investors have to meet strict government standards, which include: overseas assets of at least $100 million, and requirements that they buy at least 10 percent of the target company and hold their stake for a minimum of three years (Lineabugh 2006, A6). This program is intended to provide momentum for the ongoing process of conversion of non-tradeable shares to tradeable shares, a conversion that may increase opportunities for foreign investors.

Venture Capital Activities

Overall Structure

The venture capital industry also has been dominated by the government. Venture capital made its first appearance in China in 1985, with a government decision to develop high technology industries and the formation of the first venture capital firm, the government-sponsored China Venturetech Investment Corporation. Although initial government-backed investment operations generally failed, there has been resurgence in venture capital activity since China's admission to the WTO (Kenny, Han and Tanaka 2002, 106-109). Venture capital investment has grown rapidly from $418 million in 2002 to more than $1 billion in 2005, invested in 233 China mainland or mainland-related enterprises (Zero2ipo 2005). Most domestic venture capital firms are managed by government officials – for example, Shenzhen Capital Group, one of the largest domestic venture capital firms, is wholly owned by the Shenzhen municipal government – and nearly half of the capital of the firms comes from government entities (OECD 2005, 158; EIU 2006d, 49).

Under current rules, applicable to both domestic venture capital firms and foreign-invested venture capital enterprises in China (FICVEs), firms are subject to the highest statutory tax rate of 33 percent on capital gains and have very limited exit routes through domestic or overseas stock markets. In 2005, Chinese authorities issued new guidelines, scheduled to go into effect in 2006, intended to foster domestic venture capital firms. The new guidelines recommend that local governments provide financing assistance, favorable tax treatment, and direct investment in Chinese venture capital firms. They also provide less stringent capitalization, investment amount, investor qualification and regulatory requirements than those applicable to FICVEs (Guerrera, Yee and Yeh 2005, 30).

FICVEs are governed by 2003 regulations that include high investment and qualification thresholds, government approval requirements, and strict foreign exchange limitations on the ability to remit profits and dividends back to the investor (Hoo, et al 2005a). Substantial legal and de facto restraints on the ability of both FICVEs and domestic firms to access the stock markets in China and overseas for IPO listings make exit strategies extremely difficult (box 3). For these reasons, foreign venture capital firms investing in China usually do not use FICVEs but instead rely on offshore holding companies created to receive their investments.

Box 3 The Challenges of Venture Capital Activity in China

- Lack of a NASDAQ-like exchange for exits for venture capital investments
- Legal constraints on the use of off-shore legal structures for investments and overseas IPOs
- Weak intellectual property protection, making it difficult to capitalize on valuable intellectual property and innovation
- Lack of a comprehensive venture capital law addressing structure and taxation of venture capital firms, making it difficult to raise institutional funds
- Shortage of management talent
- Underdeveloped systems for technology transfer between research institutions and companies that can commercialize innovations
- Substantial governmental control over venture capital landscape resulting in disincentives for entrepreneurs and investors

Source: Ernst & Young Venture Capital Advisory Group 2005, 5.

Competitive Conditions for Foreign Firms

The regulations governing foreign venture capital investment are chaotic and changing. Until recently, foreign venture capital firms (most of which are U.S.-based) investing in China generally have done so through the restructuring of Chinese companies into offshore investment vehicles; these enable an easier exit from investments either by selling shares on international stock markets or through a trade sale to another foreign buyer. In January of 2005, however, Chinese authorities brought these transactions to a virtual standstill, with the issuance of new regulations preventing any onshore resident from establishing, controlling or owning shares in an offshore company, either directly or indirectly, without the approval of the Government. The regulations were intended to stop managers of SOEs receiving venture capital investments from stripping state assets and selling them cheaply to overseas companies, and to preclude domestic companies from using the overseas vehicles to gain foreign investor tax exemption status. However, they choked off legitimate transactions as well. There were no government approvals of offshore investment transactions in 2005. With only limited exceptions for transactions in process, foreign venture capital financing through offshore investment vehicles screeched to a halt in 2005 (Borrell 2005).

Then, in November of 2005, the Chinese authorities issued superseding regulations. These require registration of offshore investment vehicles with the State Administration of Foreign Exchange (SAFE), but do not require the agency's approval of the transaction. They also require repatriation of all distributions of income from the investment within a fixed time frame. Like the previous regulations, the new ones do not describe specifically the registration process, the procedures involved, the scope of review nor the time required for completion, creating substantial uncertainty for foreign venture capital investors (Hoo, et al 2005b). Despite this changing regulatory landscape, many U.S.-based venture capital firms have active plans for substantial investments in 2006 – spurred by China's high growth potential, the success of recent venture-backed startups on the NASDAQ including Baidu.com and China Medical Technologies – and by pent up demand after the 2005 halt in new investments (Borrell and Aragon 2005).

Bond Markets

Overall Structure

The development of China's bond market has lagged behind even that of the stock market, due in part to government dominance of the corporate bond approval process (Hirson 2005, 38). The bond market is made up of an inter-bank bond market and an exchange-traded bond market. The inter-bank bond market is a quote-driven over-the-counter (OTC) market that serves as a platform for PBOC open market operations and block trading of bonds among financial institutions. The exchange-traded bond market is order-driven and includes: government treasury bonds (T-bills), bonds issued by the policy banks (used to finance development projects) and corporate bonds. The dominant players on this market are the securities and insurance companies; banks have been excluded from the market since 1997 (CSRC 2005, 29).

The government bond market is the largest and best developed (table 4). T-bills and policy bonds account for 86 percent of all traded debt (excluding non-performing loans). At 13.7 percent of all traded debt, China's corporate bond market is one of the smallest in the emerging economies of East Asia, particularly since most of the issuances are by the policy banks. By contrast, in Malaysia, corporate issuers account for 39.4 percent of the bond market and 31.3 percent in Thailand (Asian Development Bank 2005, 5).

Table 4 Funds Raised in China's Bond Markets, 2005

	Total (USD Billion)	Percentage Share
Government treasury bonds	86.94	47.1
Policy bonds	72.25	39.2
Corporate bonds	25.27	13.7

Source: PBOC 2006b, 24.

A state-decreed moratorium on corporate bond issues, following defaults by the SOEs, severely limited corporate bond issuances in China in the 1980s and 1990s. Although the moratorium eased in 1999, only large SOEs have been permitted to issue bonds and they must carry an unconditional and irrevocable guarantee. The market's development has been limited by regulations focused on restricting the price, interest rates and conditions of the bonds, rather than ensuring adequate financial disclosure. The dominance of industrial policy considerations in the corporate bond approval process also has limited market development (OECD 2005, 159-60).

Corporate bond market activity improved in the second half of 2005, when the PBOC allowed companies to issue commercial paper with maturities of up to one year without approval from the National Development and Reform Commission (NRDC), the agency otherwise in charge of approving corporate bond issuances. Other plans to stimulate the debt markets include: the opening of a new exchange in Shanghai dedicated to the trading of financial derivatives (after a ten-year ban following scandals involving treasury futures in the 1990's); a new OTC market to facilitate bond trading among financial institutions; and increased efforts by the CSRC to promote commercial asset-backed securities (Anderlini 2006). Opening the corporate bond market to a wider range of companies, particularly private firms, is critical to the reinvigoration of the financial sector and to reducing the over-reliance on bank loans to meet financing needs.

Competitive Conditions for Foreign Firms

China's corporate bond market is generally closed to foreign issuers (EIU 2006d,130). Outside of the corporate bond market, however, China implemented reforms in 2005 that provided some additional opportunities for foreign bond issuers and investors. In October, China announced that it would, for the first time, allow foreign issuing entities into the domestic market, permitting the International Financial Corporation of the World Bank and the Asian Development Bank to issue RMB-denominated Panda Bonds, to be used to fund private-sector development. China hopes that the opening will bring international finance-related skills and more issuer diversity to the bond market (Asia Pulse 2005a). On the domestic interbank bond market, foreign capital commercial banks recently have been permitted to join the bond underwriting consortium to underwrite bond issues. Foreign bank transactions in the interbank bond market have been increasing since 2001 and continued an upward trend in 2005 (Asia Pulse 2005b). Also, Qualified Foreign Institutional Investors (QFIIs) are permitted to invest in bonds listed on the stock exchange, subject to quotas. Despite this measured progress, there has been no loosening of the corporate bond approval process to permit the expansion and diversification of the corporate bond market.

Conclusions

Banks, stocks, bonds and venture capital act as financial intermediaries that, in a well functioning system, supply capital to the efficient users and weed out the inefficient ones. Thus, banks monitor firm profitability and performance of loans, stock and venture capital markets provide a market for governance and bond markets price risk. These valuable functions do not occur efficiently in China; private enterprise is hampered and inefficient enterprises are kept afloat by "policy lending" (making sure that favored borrowers get capital). Given the limitations of the financial sector described here, it is perhaps surprising that China consistently has attained high rates of economic growth. Not all SOEs are inefficient, and private firms that are able to access the necessary capital, often on the informal markets, have contributed greatly. Redirecting more financing from SOEs to private enterprises could increase the efficiency of investment and significantly improve returns for the large number of households that hold their savings in low-yield bank deposits and in cash. Greater access to the banking, equity, venture capital and debt markets for domestic and foreign private firms, as well as increased attention to the implementation of international standards of lending and market regulation, will help foster greater internal competition and productivity within China's economy.

Reform is occurring, spurred in great measure by China's WTO commitments and the need to make fundamental improvements prior to December of 2006, when foreign banks are to be permitted entry on a national treatment basis. Further analysis, once the changes to the regulations governing foreign banks have taken effect, would better inform the discussion of the evolution of China's financial sector.

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