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China's Opening to the World: What Does It Mean for U.S. Banks?

*by Valentine V. Craig**

China has agreed to open its financial system to full foreign competition in December 2006 in accordance with its commitments to the World Trade Organization (WTO). In regard to banking, it has committed to remove all geographic, client, and nonprudential restrictions on foreign banks. What does this financial opening mean for foreign banks? This article examines in detail the opportunities and risks of entry into the Chinese market for U.S. banks.

China, with 1.3 billion people, is a huge market, and it has been growing rapidly since the early 1980s with no end in sight. This growth has produced abundant opportunities in China for financial services providers. The article begins with a review of recent statistics on Chinese growth and prosperity. It then appraises the competitive landscape for U. S. banks in China, examining the Chinese capital markets, the official Chinese banks, the informal Chinese banks, and foreign banks currently operating in China. The article then looks at the specific opportunities opening up in China in retail, commercial and investment banking.

Doing business in China is not without risk. There are economic, political and demographic trouble spots in the economy that could affect businesses operating in China. The article examines these risks. It discusses fears of an overheating market, possible protectionism by those countries to which it exports its goods, rising economic inequality in the country, and China's rapidly aging population. It then proceeds to look at the risks arising from an uncertain regulatory environment and a large unwieldy government bureaucracy. Corporate governance is generally not good, and the article reviews problems with corruption and lack of transparency in Chinese businesses, focusing particularly on Chinese banks. It then appraises the systems for ensuring a safe return of capital, concentrating on the adequacy of China's bankruptcy laws, the enforcement of contracts and legal judgments, the adequacy of its credit infrastructure, the availability of crucial personnel, and the government's commitment to open competition.

The article ends with a summary of the analysis and concluding remarks.

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An Overview of China's Economy and Financial System

China's economy has grown tremendously over the past 20 years, as recent economic statistics make clear. This has created a demand for capital by private businesses in China, which the official domestic providers of capital—the Chinese capital markets and Chinese banks—beset with problems and focused on state-owned businesses, have not been able to satisfy. However, the government has been working to make the markets and banks more efficient and competitive and to combat fraud within them, and has made some progress. Additionally, many of the illegal "gray market" banks are currently a competitive force, and foreign banks have doubled their asset size in China over the past several years.

Recent Economic Statistics

Since the beginning of China's open door policy in 1978, it is estimated that per capita income has increased seven times; 400 million people have risen from extreme poverty; and a middle class of approximately 100 million people has developed. *The Economist* credits China with "probably the most dramatic burst of wealth creation in human history."[1] Recent economic statistics reveal just how tremendous China's economic growth has been.[2]

China's gross domestic product (GDP) reportedly grew 9.5 percent in 2004, following 9.3 percent (revised) growth in 2003.[3] The growth in these two years followed average annual growth in the 1980s of 9.3 percent, and between 1991 and 2003 of 9.7 percent. Industrial capacity grew strongly in 2004, with industrial businesses' value-added increasing 11.4 percent over the previous year. The sale of consumer goods increased 13.3 percent. Exports were up 35.4 percent and imports up 36 percent, with the nation reporting a trade surplus of U.S. $32 billion for 2004. Furthermore, the WTO reports that China replaced Japan as the world's third-largest exporter in 2004.[4]

Although many of the Chinese people are poor, their financial situation is improving. Real per capita growth rates of disposable income for both urban and rural households in 2004 were the highest they have been since 1997: 7.7 percent for urban households and 6.8 percent for rural households.[5] And as mentioned, approximately 100 million Chinese are considered middle class and middle income. The urban unemployment rate is a low 4.2 percent—0.1 percent less than in 2003. While inflation has increased (it increased 3.9 percent in 2004, following a 1.2 percent increase in 2003), it is quite moderate given the tremendous growth of the economy. Additionally, the Chinese people are great savers, saving over 40 percent of GDP. Reported savings of households increased over 15 percent in 2004.

Capital Markets

There are two stock exchanges in mainland China—the Shanghai and Shenzhen exchanges. They are generally considered undeveloped and corrupt. However, the government has been working to improve the corporate governance of these exchanges. There is a large government bond market, but the corporate bond market is insignificant.

[1] *The Economist* (2004d), 11.

[2] Some analysts believe that growth has not been as great as officially reported because of suspect data. Official Chinese economic statistics, although improving, are generally considered unreliable. The World Bank estimates that China overstated its growth between 1978 and 1995 by 1.2 percent a year; the OECD believes the overstatement was 3.8 percent between 1986 through 1995 (Lardy 2002). Unlike most developed countries, China does not seasonally adjust its statistics, and the lack of seasonal adjustment can distort recent activity. Other analysts question the accuracy of the raw data themselves. *Business Report* (2004) suggests that economic figures should be viewed as "highly manipulated political statements" rather than hard numbers. Even trade statistics are not considered reliable. The *New York Times* (2004) reports that some companies exaggerate exports to claim tax credits, and others underreport imports to avoid customs duties. Despite all these qualifications, however, there is general agreement that China's economy has grown tremendously over the past two decades, although less than officially reported.

[3] National Bureau of Statistics of China (2005).

[4] World Trade Organization (2005).

[5] World Bank (2005).

Stock Exchanges. The two stock exchanges were formed in 1991 and 1992 primarily to fund the government's bailout of failing state-owned enterprises. Currently there are approximately 1,300 predominately state-owned enterprises listed on the two exchanges with a combined total market value of $400 billion. In most countries, companies with the best prospects typically launch IPOs, but as the Chinese government—rather than independent underwriters—is responsible for deciding which companies to list in China, until very recently, these companies were—with a few exceptions—failing state-owned enterprises.

To maintain control of these state-owned assets, the government issued two general types of securities—state-owned shares or legal-person shares, which are not allowed to trade, and tradable shares. Approximately two-thirds of the shares of listed firms are the former. With so many shares not permitted to trade, the market is very illiquid. Fear of the state-owned shares being dumped on the market has reportedly kept share prices low despite the booming economy and has discouraged the development of derivative and corporate bond markets.

The exchanges offer A-shares and B-shares. A-shares are denominated in renminbi (or yuan), the Chinese currency, and are available for sale only to Chinese nationals; B-shares are foreign currency denominated, and foreigners are allowed to purchase them.

Domestic companies can also list in Hong Kong ("H" shares or "Red Chips"). This exchange and the companies it lists are generally considered better than those on the mainland. However, the Hong Kong exchange has some governance issues, according to shareholder activists.[6]

Some domestic companies also list overseas. The best-performing state-owned enterprises and private companies, in addition to listing in Hong Kong, list overseas on the New York, NASDAQ, or Singapore exchanges.

The mainland Chinese stock markets have had serious problems with corruption, cronyism and lack of transparency. *Euromoney* describes these markets as "mired in corruption, dominated by moribund companies and manipulated by government and speculators alike."[7] Corruption extends beyond the exchanges to include listed companies. The China Securities Regulatory Commission (CSRC), which regulates the securities market, reported in 2004 that 10 percent of its listed companies had doctored their books.

Improvements are being made: the CSRC has recently taken steps to improve the functioning of the two exchanges. It is in the process of ending the differential treatment of its A-shares and B-shares. Additionally, foreigners can now apply to buy the state-owned shares, albeit with significant restrictions, and more private companies are being allowed to list. On May 1, 2005, the government announced a pilot program under which it would begin to sell a small number of state-owned shares in a controlled way to avoid any disturbance in the markets. The expectation is that this will alleviate the depressed value of the listings and make the market more liquid.

The CSRC is also tackling corruption. It is investigating related-party transactions to stop the prevalent practice of shifting assets from listed companies to their unlisted state-owned parents. It plans to examine all related-party transactions where the price of assets bought or sold deviates more than 20 percent from an independent appraisal. Additionally, the CSRC has been monitoring brokerages for malfeasance and in 2004 it seized control of the fifth largest broker for corruption and mismanagement.[8]

Bond Markets. The government bond market is large. But although a great number of government bonds are issued,[9] the four largest Chinese banks typically buy 60 to 70 percent of any treasury issue, effectively setting the bond's price. Doubt about the true value of the debt has

[6] Wehrfritz (2005).
[7] Leahy (2004), 92.
[8] *Economist* (2004b), 19.
[9] At the end of 2004 there were approximately $127 billion in treasury bills outstanding, and $268 billion in one- to ten-year notes and bonds outstanding (*The Standard* [2004]).

encouraged a buy-and-hold market, and this illiquidity deprives companies of favored instruments for hedging short-term risk.

The corporate bond market is tiny.

Chinese Banks

The Chinese banking system is very large because of its preeminent role in financial intermediation, the large economy, the high level of household savings, and restrictions on overseas investments.[10] It is predominantly state-owned. Given the very weak capital markets in China, the banking system provides an estimated 80 percent to 90-plus percent of all business funding. In early 2005, total bank loans to government-owned and private businesses represented approximately 160 percent of Chinese GDP, up from 120 percent in 2000.[11] Consumer loans, a relatively new development in China, constituted approximately 10 percent of all outstanding bank loans in early 2005. Of these consumer loans, mortgages accounted for approximately 90 percent.[12]

There are four big state-owned commercial banks, established originally to fund large state-owned enterprises. There are, in addition, 12 joint-stock commercial banks (JSCBs) owned by local governments, domestic investors, or foreign investors; an estimated 35,000 rural credit cooperatives; three policy banks, which focus specifically on economic development; over 100 city commercial banks, which are restricted to doing business in their base city only; and numerous rural commercial banks, urban credit cooperatives, and finance companies.

The big four banks are the Industrial & Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China, and Agricultural Bank of China. At the end of 2001, collectively they employed 1.4 million people and had 116,000 branches across China. Although the big four banks represent the largest banking bloc in China, with almost two-thirds of total deposits in September 2003, the JSCBs have been taking market share from them. In September 2003, the share of deposits held by the big four had declined to 64.9 percent from 68.3 percent in March 2002, whereas the share held by the JSCBs had increased to 14.7 percent from 12 percent over the same period.[13]

The rural credit cooperatives accounted for approximately 12 percent of deposits in September 2003. These cooperatives are responsible for providing credit to small factories, farms, and households in smaller cities and rural areas. The government-owned policy banks (China Export and Import Bank, China Development Bank, and Agricultural Development Bank of China), the city commercial banks, foreign banks, rural commercial banks, urban credit cooperatives, and finance companies collectively accounted for the remaining (approximately) 8 percent of deposits in September 2003.

The country's central bank, the People's Bank of China, is in charge of monetary policy. One of its powers is to set interest rates on deposits and loans. The China Bank Regulatory Commission (CBRC), established in April 2003, regulates and supervises all banks.

Problems with the Banks. The original mission of Chinese banks was to act as a government-directed funding source for state-owned enterprises. The banks continue to lend primarily to these dying state-owned businesses, ignoring the growing vibrant private businesses in their midst. The big four state-owned banks in particular were used by the Chinese government as instruments to implement government development policy. They had little or no discretion as to borrowers or loan terms. Borrowers were approved by the government, which set identical loan rates for every borrower regardless of risk. These conditions did not support a market-oriented lending approach:

10 Prasad (2004).
11 *Business Week* (2005).
12 *The Economist* (2005f).
13 Ibid.

credit analysis and risk management, for instance, were unnecessary and not performed.

The political interference, along with corruption and lack of modern management skills, has resulted in high levels of nonperforming loans in Chinese banks. (This is covered in greater detail in the section below entitled "A Look at the Risks.") Standard and Poor's (S&P) estimated in September 2003 that approximately 45 percent of bank loans were bad. In 2005, on the basis of substantial government assistance to the banking industry, it lowered its estimate to approximately 31 percent, or approximately $700 billion in bad loans.[14]

Other analysts are less optimistic and believe that the banks made a substantial number of additional bad loans through early 2004, before a government crackdown on lending began. For instance, bank lending increased 56 percent in 2003 over the previous year, with much of this new lending directed to funding state-owned businesses and infrastructure improvements at the government's behest. Banks also started aggressive lending to consumers at this time. Consumer loans now constitute 10 percent of outstanding bank loans. While it is too soon to estimate the full extent of new bad loans made during this time, the state National Audit Office warned in June 2004 that it was beginning to see widespread consumer loan problems. Auto loans are of particular concern. Volkswagen of China reported that 5 percent of auto loans in Beijing are in default. Other reports suggest that approximately 50 percent of car loans are overdue.[15]

Official government figures for nonperforming loans are lower than the figures from other sources. The government estimates nonperforming loans at the end of 2004 at approximately 13 percent of total loans.

Recent Banking Reform. The Chinese government is trying to resolve the banks' financial problems before national treatment is afforded to foreign banks in December 2006. The government's approach is multifaceted: it has given the banks more discretion in their lending decisions; has tried to help the banks maintain their deposit base against the inroads of "gray-market" banking; has provided massive cash injections to rid the banks of bad loans; is working to improve corporate governance at the banks, including clamping down on corruption within the banks; and is trying to attract foreign investment to the banks, hoping that foreign involvement will spur local banks to acquire Western management practices, expertise, and capital.

Greater discretion in lending decisions was recently granted to introduce banks to the concept of risk-based lending. In January 2004, the CBRC permitted banks to charge risky borrowers up to 70 percent over the benchmark lending rate. Previously they had been allowed to charge a maximum rate of up to 30 percent over the standard rate, and before that they had not been allowed to differentiate at all between borrowers in setting rates.

Additionally, to help the "official" banks maintain their deposit base in the face of the substantially higher rates on deposits being offered by the "gray-market" banks (see below), in October 2004 the central bank raised interest rates on one-year loans and on deposits by 25 basis points.[16]

The government has also been pressing the banks to deal with billions in bad debt before full foreign competition begins. In the late-1990s, the government tried—unsuccessfully—to resolve the banks' bad loan problem. In 1998 the government infused $32 billion into the banks. In 1999 it purchased $170 billion in bad loans (at book value), which it then transferred for disposal to asset management companies created for this purpose.

[14] As a means of comparison, at the height of the U.S. savings and loan crisis of the 1980s, nonperforming loans (defined most broadly) of U. S. thrifts never reached 5 percent of total loans of U.S. thrifts.
[15] *The Economist* (2005f), 73.
[16] However, this very small movement in rates is not considered likely to affect the deposit drain from the official banks to gray-market banks.

The CBRC is also working to improve corporate governance at the banks, with particular emphasis on uncovering and preventing corruption. (Corruption is widespread at the banks, and is discussed in greater detail in a later section). The CBRC issued new regulations in early 2005 requiring banks to monitor senior management and board members through internal monitoring and independent external auditors and to establish internationally accepted risk management controls. To deal with widespread rural bank fraud, the CBRC is planning to restructure and consolidate the 35,000 rural credit cooperatives into a more manageable 2,000 institutions by 2007.[17] The CBRC has also begun to publicly report corruption uncovered at the banks.

Finally, the government has been encouraging foreign banks to take minority positions in Chinese banks. To make the big four banks more attractive to foreign investors, the government bailed out two of them in December 2003 and a third bank the following year. Bailed out were the Bank of China, which the government plans to list in Hong Kong, and CCB, which the government plans to list in New York and Hong Kong. The two banks together were estimated to be more than $65 billion in debt; each received a direct infusion of $22.5 billion to bring its capital above the minimum set by the Bank for International Settlements and to lower its nonperforming loans. The government then made a $15 billion capital infusion into ICBC (the nation's biggest bank, with 20,000 branch offices and 400,000 employees),[18] intending to list it in 2006. The remaining big-four banks, Agricultural Bank of China, and a dozen or so smaller banks are also expected to list their shares eventually. It is expected that listing will encourage foreign ownership in the banks.

"Gray-Market" Banks. The gray-market banks are informal or sometimes well-organized, groups of lenders/investors. These informal banks reportedly provide much of the lending to small private sector businesses that do not have the political connections to borrow from the state-owned banks.[19] They may consist of only a few individuals—family or friends of the borrower—with a little money to invest, or they can be large sophisticated lending cooperatives organized by rich entrepreneurs in search of higher yields. Annual interest rates on loans made by gray-market banks range from 8 to 20 percent, providing returns to investors substantially above the 2.25 percent official bank deposit rate. Consequently, the gray-market banks compete with the state-owned banks for deposits.[20]

Some of these informal banks are quite large and highly efficient, competitive lenders, providing millions of dollars in structured financing to private businesses. Some of them reportedly borrow the money for their lending from the big four banks and them re-lend it to private borrowers at the higher rates.[21] Defaults are rare due to the personal nature of the lending. Although illegal (organizing a gray-market bank is a capital offense), they are widespread and are generally tolerated by the government. In fact, they are so widespread that the CBRC has reportedly begun to informally monitor prevailing gray-market lending rates.[22] The government has also bailed them out on occasion when they have failed.

Foreign Banks[23]

At the end of 2004, there were 62 foreign banks with over 200 branches operating in China with restricted licenses.[24] Many of these banks had also invested in joint ventures with Chinese banks. In April 2005, foreign banks accounted

[17] *BNA's Banking Report* (2004).
[18] *New York Times* (2005).
[19] Bradsher (2004).
[20] Real interest rates on deposits at the official banks are negative because of low interest rates (raised from 2 percent to 2.25 percent in October 2004) and inflation of 3.9 percent in 2004. [Bradsher (2004].
[21] *Business Week* (2004).
[22] Ibid.
[23] In reporting on the activity of individual foreign banks in China, the author relies upon publicly available information–for the most part, news reports or bank press releases. The activities of some very active foreign banks may be overlooked and others overstated depending upon the extent of public coverage of their activities.
[24] Foreign banks additionally had established over 200 representative offices in China by mid-2004.

for approximately 3 percent of total assets in the banking system, more than twice the 1.3 percent of total assets these banks held in September 2003.[25] HSBC Holdings and Standard Chartered, both headquartered in the United Kingdom, and Citibank, a U.S. bank, are considered the major international banks in China, having built a strong renminbi business.[26] Netherlands-based ING Bank also has a large presence, and Bank of America in June 2005 made the largest investment to date in a Chinese bank, purchasing 9 percent of CCB for $3 billion dollars.

Branches of Foreign Banks. Foreign banks in China currently operate under licenses that restrict them to specific clients and to certain geographical areas. They are permitted to provide financial services in nonlocal currencies to foreign firms in 18 cities, including Beijing. The CBRC reported that at the end of 2004, foreign banks had 18 percent market share of loans made in foreign currency. Additionally, by the end of 2004, 105 foreign branches had received local currency (called renminbi or yuan) licenses, permitting them to collect deposits and make loans in renminbi in these same 18 cities. Of the 105 foreign branches with renminbi licenses, 61 have been permitted to provide renminbi services to Chinese firms in addition to foreign firms.[27] A major exclusion for these foreign branches is that they are not permitted to provide consumer services to Chinese individuals.

In addition to client and geographical restrictions, the government has also used stringent licensing requirements to discourage the growth of foreign bank branches. Until recently, foreign banks were required to wait a year between branch openings in a city, and to maintain high minimum capital levels. In 2004, the government did away with the year's wait and cut the minimum capital requirement for new branches. Foreign bankers claim that the lowered capital requirement still represents a barrier to entry in smaller cities.

Foreign Joint Ventures. Despite the many problems of domestic banks, many foreign banks have also purchased minority positions in domestic banks to avoid existing client, geographic and branching restrictions and to obtain access to the domestic banks' extensive branch systems. The government currently permits up to a total of 24.9 percent foreign stake in any one domestic bank (19.9 percent by any one foreign entity). The government has also provided incentives to encourage foreign minority interest in Chinese banks. A significant incentive has been a lower tax for foreign businesses than for domestic businesses.

In certain cases the government has also permitted significant concessions to foreign investors in Chinese banks. For example, Newbridge Capital, a U.S. private equity firm, recently bought 18 percent of Shenzhen Development Bank, a joint stock bank, and was permitted to appoint a majority of the board, ceding control of a Chinese bank to a foreign entity for the first time. And American Express was recently able to negotiate an agreement with Industrial & Commercial Bank of China under which the bank assumed all risk for the joint American Express card the two firms issued.

One of the largest foreign investments in a Chinese bank is HSBC Holdings' 19.9 percent share of Bank of Communications (BoCom), China's fifth largest bank, which HSBC purchased for $1.75 billion. HSBC was able to negotiate government assistance and some protections. The government bailed out BoCom before the acquisition: BoCom's current reported level of nonperforming loans is 3.4 percent. Its agreement also permitted HSBC to appoint two of the eight seats on BoCom's board of directors, which is expected to assure some level of control.[28] Additionally, PriceWaterhouseCooper is reorganizing BoCom's risk management and accounting systems and Goldman Sachs is restructuring BoCom in preparation for its public listing.

[25] International Monetary Fund (2005).
[26] Dolven et al. (2004).
[27] *China Daily* (2004).
[28] Dolven et al. (2004).

A Look at Financial Opportunities

The demand for financial services in China is huge and growing. Foreign bank interest in China speaks to the attractiveness of this market. A rising standard of living has sparked a growing demand by Chinese consumers for financial services, opening up opportunities for banks in wealth management, credit cards, mortgage loans, auto loans and other consumer loans. Economic growth has also produced a growing demand from private businesses for commercial and investment banking services. Emergent opportunities for foreign banks include providing loans to smaller businesses, deposit-taking, risk management services, debt and equity underwriting, mergers and acquisitions, brokerage, asset management, and disposal of bad loans.

Opportunities: Retail Banking

Some foreign banks view retail banking as a tremendous opportunity due to growing consumer demand and limited domestic competition. Chinese consumers are off-limits to foreign banks until December 2006, which has prompted some foreign banks to take minority positions in Chinese banks to prepare for this financial opening.

Although personal financial services account for an insignificant percentage of the earnings for China's banks—3 percent in 2003—this represents a huge increase over the past few years.[29] And, with a new middle class of approximately 100 million consumers, the demand for credit cards, mortgage loans, and automobile loans is expected to increase further. McKinsey, a business consulting group, is projecting a compound annual growth rate for personal financial services in China of 31 percent through 2013.[30] McKinsey considers two segments of the population attractive targets: the affluent, the top 2 percent of banking customers who currently account for over half of retail banking profits in China, and the "mass-affluent" the 18 percent of Chinese bank customers who are responsible for most of the remaining profits.[31]

Existing competition is weak. The personnel and technology of Chinese banks generally do not meet international standards and the local banks typically have not made customer service a priority.[32] Additionally, recent forays into consumer lending by Chinese banks have been generally unsuccessful. A lack of experience in consumer lending, inadequate systems for sharing financial information, falsified financial documents and other fraud by borrowers, and difficulties in foreclosing and gaining title to collateral have produced a number of bad consumer loans. (This is covered in greater detail in a later section on risks.)

As described, many large foreign banks, anxious to get a head start in consumer banking before the opening, have allied themselves with Chinese banks to offer wealth management; credit cards; and mortgage, auto, and other consumer loans. Many foreign banks have found city banks especially attractive investments. Restricted to operating in a single city, city banks often have close customer relationships. Additionally, there are 34 cities in China with more than one million inhabitants, so city banks can provide substantial penetration. The CBRC has also said that it may eventually allow city banks to expand into other areas of China.

Wealth Management. Chinese banks are permitted to sell mutual funds and to provide custody services to bank customers, but not to manage funds themselves. However, in February 2005 the CBRC initiated a pilot program under which banks would be permitted to launch funds on their own or with partners. Firewalls between a commercial bank's banking operations and its fund management business are required.[33] The central bank is expected to approve bank mutual funds at the end of September 2005.

[29] *BNA's Banking Report* (2004) reports that consumer loans increased from $17 billion in 1997 to $200 billion in 2004.
[30] Von Emloh and Wang (2004).
[31] Ibid.
[32] *BNA's Banking Report* (2004).
[33] *China View* (2004).

Fund sales have been a significant recent area of growth for some Chinese banks. In particular, CCB, the second largest bank in China, has been active in this area. CCB has 136 million active retail accounts and 14,500 branches across China. It reports that through March 2004 it sold 26 different mutual funds to investors with a sales volume of approximately $3.74 billion.[34] As mentioned, Bank of America recently purchased 9 percent of CCB to access its tremendous network and capabilities.

ING Bank of the Netherlands and the International Finance Corp (World Bank) together own 24.9 percent of the Bank of Beijing, the second largest of China's city commercial banks, which has a large and growing consumer savings base. ING plans to offer wealth management services and insurance to these consumers through its venture partner. ING has stakes in five other Chinese banks and is engaged in joint ventures with Chinese firms in fund management and insurance as well.[35]

Credit Cards. At the end of 2004, credit cards accounted for 3 percent of consumer purchases in China. American Express (AMEX) expects that penetration will eventually match Hong Kong's 20 percent rate.[36] McKinsey believes foreign banks have a special advantage in credit cards because of a traditional Chinese unwillingness to lend without collateral and domestic banks' lack of marketing and risk assessment skills.

Foreign banks have begun to move into the credit card area through investments in domestic banks. For instance, Citibank purchased 5 percent of Shanghai Pudong Development Bank, the ninth largest commercial bank in China, with 270 branches in major cities.[37] The joint venture recently began to offer Chinese consumers international credit cards, denominated in renminbi within the country and in U.S. dollars outside of China. The card carries Citibank's logo. HSBC has partnered with the Bank of Shanghai, of which it owns 8 percent, to offer credit cards. AMEX, with ICBC, recently launched the country's first dual-currency American Express Card. Beginning in 2005, the government began to allow renminbi-currency credit cards to be used outside of China. They can be used in South Korea, Singapore, and Thailand; transactions related to gambling, interbank transactions, and capital-account items are prohibited.

Mortgage Loans, Auto Loans, and Other Consumer Loans. Over five million new homes were built during the past five years in China.[38] During the next decade economic growth is expected to provide home ownership opportunities for hundreds of millions of Chinese. KGI, a securities firm, reports that the number of mortgages grew at an annual compound rate of 115 percent between 1998 and 2004.[39] As noted above, mortgages account for 90 percent of outstanding consumer loans of $242 billion.

China is currently the world's third-largest car market (after the United States and Japan), and some analysts expect it to overtake the United States (number one) by 2015. Demand for cars in China increased 56 percent in 2002 and 75 percent in 2003 before falling to a 15 percent growth rate in 2004, as the government tightened bank lending. Approximately 30 percent of autos were financed by loans in 2003; the figure dropped to 10 percent in 2004 in response to the tightened lending.

The demand for consumer goods of all types has increased dramatically in China, and not just in the large cities. More than half of the consumption of many consumer goods has occurred in the nation's smaller cities and rural areas. HSBC has positioned itself to take advantage of this growing demand. Its investment in BoCom, described earlier, provides HSBC—through BoCom's 2700 branches—with access to 139 cities in China and massive consumer lending opportunities.

[34] *Lafferty Limited* (2005).
[35] *The Economist Intelligence Unit Ltd.* (2005d).
[36] *Forbes.com* (2004).
[37] *BBC News* (2003).
[38] Woetzel (2004).
[39] *The Economist* (2005f), 73.

Opportunities: Commercial and Investment Banking

Foreign banks are currently providing commercial and investment banking services for foreign businesses operating in China, and have begun to provide limited financial services for Chinese businesses, as permitted.

Foreign businesses in China include multinational businesses, such as Volkswagen, which produces cars for the domestic Chinese market, and other multinationals, such as Wal-Mart and General Electric, that are export-driven. Most foreign businesses operating in China are smaller, export-driven, mostly Asian-owned businesses; these businesses represent higher-margin lending opportunities than the multinationals. Small and medium-sized Chinese businesses, starved for financing at a reasonable cost by the state-owned banks, also provide commercial and investment banking opportunities.

Smaller private businesses present particularly attractive commercial and investment banking opportunities in China. These growing businesses provide opportunities in risk-based lending and corporate deposit-taking; equity and debt underwriting, trade financing, merger and acquisition assistance, brokerage services, and asset management. There are also opportunities for foreign banks in disposing of the huge amount of bad loans held by Chinese banks and asset management companies.

Risk-based Loans and Deposit-taking. Private businesses in China account for approximately 60 percent of China's GDP and 70 percent of employment. As mentioned earlier, ignored by the state-owned banks, they are often forced to pay interest rates of as much as 8 to 20 percent or more for loans from gray-market lenders, if they are able to get them at all. This market continues to be underserved. McKinsey estimates that total bank revenues from loans to small and medium-sized businesses in China could exceed $25 billion by 2010; in 2002, they accounted for less than $10 billion.[40] HSBC Holdings, in particular, has focused on lending to smaller companies in China.[41]

McKinsey also sees corporate deposit taking as an attractive area of business for foreign banks. McKinsey estimates that deposits are likely to grow at approximately 18 percent annually through 2010, generating more than $20 billion to banks by 2010.[42]

Risk Management Services. In March 2004, the government introduced rules permitting foreign banks to trade derivatives directly with Chinese businesses. The new legislation allows for asset-related derivatives in credit, fixed income, foreign exchange, and hedging. ABN AMRO estimates revenue from interest rate derivatives at approximately $500 million a year and increasing, and plans to expand its derivatives business from foreign-currency hedging to interest rate swaps and to commodity and equity derivatives.[43] By the end of 2004, ten banks had received licenses to trade derivatives.

Debt and Equity Underwriting, Trade Financing, and Mergers and Acquisitions. A recent study by Mercer Oliver Wyman (a global financial services and risk management firm), in conjunction with Morgan Stanley and UBS AG, estimates that earnings from fees for investment banking services in non-Japanese Asia for 2004 were approximately $5 billion, an increase of 30 percent over 2003. *Bloomberg News* reports that the market for debt underwriting in non-Japanese Asia doubled in the past five years and that Citigroup was market leader in debt underwriting in 2004 in this region.[44]

With the government planning to launch IPOs of state-owned banks and other state-owned enterprises, equity underwriting is expected to grow substantially. Increasing numbers of private Chi-

[40] Bowers et al. (2003). 11,
[41] Dolven et al. (2004).
[42] Bowers et al. (2003), 10,
[43] Baglole and Ng (2004).
[44] *Bloomberg News* (2004).

nese businesses are also expected to go public and to issue debt. McKinsey projects that revenues from underwriting equity and debt should grow at a compound annual rate of 13 percent to $2 billion by 2010, with half of this increase coming from medium and small businesses. Citigroup and Credit Suisse First Boston are active in underwriting IPOs. There are also opportunities in debt underwriting of private businesses: Morgan Stanley has been especially active in underwriting high-yield issues.

Businesses also need trade financing. McKinsey projects that bank revenues from trade financing could reach $5 to $10 billion by 2010. HSBC Holdings, in particular, has built a very successful trade financing network for its small corporate clients.[45] McKinsey also is projecting that merger and acquisition revenues will grow by 30 percent a year, reaching $400 million in fees by the end of the decade.[46]

Brokerage and Asset Management. Opportunities in providing brokerage services are opening. Half of China's 130 domestic brokerages are classified "at risk" and would find it difficult to provide significant competition to foreign brokers. However, China's WTO commitments in regard to securities operations are less than its commercial banking commitments. Foreign firms will not be permitted to trade A-shares, which have accounted for the vast majority of Chinese securities firms' revenues.[47] Foreign investment banks are also limited to owning a 33 percent share of domestic securities firms, a limitation that is not slated to change under the WTO agreement.[48] However, in December 2004 the government approved a joint venture between Goldman Sachs and a local securities firm under which Goldman was granted effective control. The joint venture is permitted to trade shares on domestic markets.

Asset management opportunities in China are discussed in the previous section on wealth management. As in brokerage, foreign ownership restrictions on asset management firms are to continue, with the maximum ownership by a foreign firm restricted to the 49 percent that was approved in December 2004. In April 2005, UBS purchased 49 percent of China Dragon Fund Management, a medium-sized Chinese mutual fund.

Disposal of Bad Loans. China is the world's second-largest bad-loan market (after Japan).[49] S&P estimates that there are approximately $700 billion in bad loans in China; other analysts suggest a higher figure. As mentioned, the government has been pressuring the state-owned banks to dispose of bad loans in preparation for their IPOs, and it has created four asset management companies to dispose of the loans. Through the end of 2004, the companies had sold only one-third of the $230 billion in bad loans acquired from the banks since 1999.

Some foreign banks have shown interest in this area. Citigroup purchased over 16 percent of Silver Grant International, a real estate affiliate of China Cinda Asset Management, one of the four asset management companies. Credit Suisse First Boston has also been active in this market, recently purchasing a 2.4 billion yuan ($290 million) package of distressed loans from China Orient Asset Management Corporation, another of the four asset management companies.

A Look at the Risks

Although the exploding Chinese economy may be the envy of the world, there are potential economic, political and demographic problems. Major areas of concern are that the economy might be overheating, that countries on which China relies to buy its exports may become protectionist, that growing economic inequality could produce internal strife, and that the rapid aging of the population may create economic difficulties.

[45] Dolven et al. (2004).
[46] Bowers et al. (2003).
[47] Lardy (2002), 72.
[48] McGregor and Guerrera (2004).
[49] Pesek (2004).

Other significant problems exist as well. The regulatory environment is uncertain, and a large unwieldy government bureaucracy continues to play a crucial role in many areas of business operation. Local party officials and local government officials are powerful and often corrupt and obstructionist. Within the banks themselves, corruption is widespread. The operations of Chinese businesses, including the banks, lack transparency. The legal system lacks impartiality, and it is generally accepted that judges continue to be influenced by party and government leaders and bribery. Bankruptcy laws are inadequate; enforcement of contracts and legal judgments is unreliable; there is an inadequate credit infrastructure and not enough trained personnel in law, accounting, and risk management; and the government's commitment to an open economic system is not always apparent.

The *Economist Intelligence Unit* awards China a rating of B for macroeconomic risk and B for financial risk. It rates China D for political stability risk, D for labor market risk, D for government effectiveness risk, and D for legal and regulatory risk.[50]

Cause for Concern: An Overheating Economy?

As described above, China's growth since the early 1980s has been phenomenal. Much of this growth is investment-based: gross fixed investment constituted 45 percent of China's GDP in 2004. This high level of investment has resulted in overbuilding and excess capacity in some sectors. The government has responded by trying to stop this overbuilding so that business profitability remains strong and the banks are not engulfed with new nonperforming loans. Rising inflation is also a concern: if increasing investment-led demand for workers and materials results in inflation, it is feared that the value of savings will be eaten away, interest rates will increase, and the gains in the standard of living that many Chinese have attained in recent years will be pushed back. This could very well create political as well as economic reverberations. Another significant source of worry is China's very low level of energy efficiency. According to the official Xinhua news agency, China consumes 4.3 times the amount of energy that the United States consumes in producing $10,000 in GDP.[51] China is a net importer of energy, whose cost has risen significantly. This lack of energy efficiency has both inflationary and competitive implications.[52]

To cool the economy, beginning in the spring of 2004, the government put curbs on new lending and investment activity. Smaller banks were forbidden to undertake new lending, requirements for investments were tightened, and new price controls were instituted. Companies were required to use more of their own capital and less debt; and provincial governments were directed to carefully review all investments in steel, aluminum, cement, and real estate and—if inflation rose—to cap price increases in electricity and transportation.

These cooling efforts apparently had some effect. Whereas the annualized *increase* in the investment in fixed assets in the first quarter of 2004 had been more than 40 percent, the increase for the whole of 2004 was 25.8 percent (following a 23.9 percent annual increase in 2003). But as mentioned, gross fixed investment still constituted 45 percent of GDP in 2004.

Government efforts to slow bank lending were not completely successful either, as local officials proved adept at "sneaking" projects by the central government. Whereas credit growth declined to a 9.3 percent increase in 2004 compared with the previous year's growth rate of 19.2 percent, the CBRC reported that Chinese banks made over $70 billion in unapproved loans in 2004, up 70 percent over the amount of the previous year.[53]

[50] *The Economist Intelligence Unit* (2005c).
[51] *The Economist Intelligence Unit* (2005b).
[52] This inefficient use of energy also contributes to significant environmental pollution.
[53] *Economist* (2005a).

The International Monetary Fund (IMF [2005]) cautions that to maintain control over its rapidly growing economy, China still needs to rein in its investment, raise interest rates, and loosen its currency. The IMF continues to be concerned about the quality of investment in China, and suggests that investment needs to be better targeted. Furthermore, although the IMF considers current inflation low given the extraordinary growth in the economy—inflation was 3.9 percent in 2004—it sees some evidence of more widespread "cost-push" pressures, especially in wages and electricity. Other analysts are concerned by the booming real estate market in certain parts of the country.

Cause for Concern: Protectionism?

In 2003, China's exports to the United States exceeded its imports by a ratio of 8 to 1. Its trade surplus with the United States that year was $124 billion—the largest bilateral trade imbalance in history.[54] The next year the trade surplus increased to $160 billion. However, China's global trade surplus in 2004 was only $32 billion, for its high level of global imports—$561 billion in goods—largely offset its global exports of $593 billion. Until the end of 2004, China's textile exports were limited by an agreed upon cap with other nations. Following the expiration of the cap, China increased its textile exports dramatically—by 29 percent in the first quarter of 2005. China is now the world's largest exporter of clothing, with 28 percent of world market share.[55] The magnitude of Chinese exports has caused consternation in the United States, the European Union, and other countries, and raises the specter of protectionism. As an export-dependent nation, China's economy would be seriously derailed by U.S. or E.U. protectionism.

China recently succumbed to pressure from the United States and other countries to raise the value of its currency. The yuan had been pegged at approximately 8.28 to the U.S. dollar for the past decade. The United States accused China of engaging in unfair trade by keeping its currency at an artificially low level against the dollar, making its exports less expensive. In July 2005, China changed the dollar peg to a peg against an unidentified basket of currencies, and at the same time allowed a 2.1 percent upward revaluation of its currency against the dollar. It also promised additional gradual movements over time. This revaluation is small and unlikely to have much effect on its exports or to satisfy its critics for long. The serious nonperforming-loan problem of Chinese banks, however, makes it extremely difficult for the government to respond to its foreign critics and to revalue its currency in a significant way. It is feared that a significant revaluation could result in increased bankruptcies and a deluge of new nonperforming loans, leading to serious economic turmoil and possibly a financial crisis.

Cause for Concern: Growing Economic Inequality

In China over 800 million people, or approximately 60 percent of the total population, continue to live in rural areas. The World Bank reports that although hundreds of millions of Chinese people have risen from absolute poverty over the past two decades and the illiteracy rate has decreased by more than half (from 37 percent in 1978 to 17 percent in 1999), great poverty still exists in China, especially in rural areas. The bank reports that over 200 million mostly rural Chinese still live on less than $1.00 a day and lack access to clean water, arable land, and adequate education and health services.[56] Credible unemployment estimates for those living in the countryside are hard to come by, but *The Economist* estimates that as many as 150 million rural Chinese are unemployed.[57]

As mentioned, official 2004 Chinese statistics report that both urban and rural households experienced the highest growth rates in per capita disposable income since 1997. (The real growth rate

[54] Thompson (2004).
[55] *Channelnewsasia.com* (2005).
[56] World Bank (2003).
[57] *The Economist* (2004d).

for urban households was 7.7 per cent, and for rural households 6.8 percent.) However, this growth was from very different bases in the two cases. According to official statistics, for city dwellers in 2004 the average per capita disposable income was 9,422 yuan ($1,138 at the official 2004 exchange rate), compared with 2,936 yuan ($355)—less than one-third the income of urban households—for rural households.[58] Also, much of the growth in income for rural areas in 2004 was attributed to high grain production and high grain prices, both of which are unlikely to be sustainable, and to reductions in taxes and fees—reductions that have contributed to a further decline in the availability of decent education and health services for rural poor people.[59]

In sum, there exists a real divide in China's standard of living between those who live in cities and those who live in rural areas. This inequality produces political and economic friction. The government has been doing a number of things to help the rural poor: it is requiring more provinces to eliminate the farm tax, directing that 70 percent of additional provincial expenditures on health and education go to rural areas, and increasing farm subsidies and government investment in agriculture.[60] Even so, economic inequality remains a growing problem.

Cause for Concern: An Aging Population

China's population is probably aging faster than that of any country in history as a result of the nation's one-child policy. Asian Demographics, a demographic research firm, describes China's population trend as "a demographic earthquake."[61] It estimates that the growth of the under-40 age bracket may have already peaked in China, and is forecasting a decline of one-third—or 250 million people—in that bracket over the next 20 years. By 2024 three-quarters of Chinese households may be childless.

This rapid aging carries with it not only all the problems that arise when there are fewer people to care for an aging population, but also the corresponding negative effect on domestic consumer demand. Based on this projected population decline, Asian Demographics forecasts annual increases in GDP in China of 4.8 percent over the next ten years and less than 4 percent thereafter, far below the 7-8 percent growth rate that many foreign investors are assuming—or the 7 percent annual growth rate that the government feels necessary to solve its rural unemployment problem. According to the firm, most marketers are not factoring this lower growth into their long-term plans.[62]

Bureaucratic Delay and Political Interference

The Chinese government is more involved in business operations than most foreign banks are accustomed. And, the government bureaucracy in China remains unwieldy and opaque. Despite reforms enacted in response to foreign complaints about the bureaucratic process—reforms such as expedited licensing—long delays caused by bureaucratic overlap remain a problem. Lone Star Funds, a global investment firm, closed its Beijing office recently because of a lack of product (bad loans) due to the long delay in getting the necessary approvals from the overlapping government offices responsible for these transactions.[63] Citigroup had to wait for almost a year for approval of its offer to buy 1.096 billion yuan in nonperforming loans—loans that the government was anxious to sell. However, in October 2004 the government announced expedited sales of nonperforming loans—for foreign buyers only.

Businesses contend not only with an overlapping national government bureaucracy, but also with local (at the village, town, city, county and provincial levels) government officials as well as local party officials. Local governments in China have exercised a great deal of power since the imperial days, and local government officials and

[58] National Bureau of Statistics of China (2005).
[59] *Economist Intelligence Unit* (2005a).
[60] *Economic Intelligence Unit* (2005a).
[61] *The Economist* (2005b), 74.
[62] Ibid.
[63] Pesek (2004).

local party officials continue to have a great deal of influence on what happens in their villages, towns, cities, and provinces. Their commitment to a market economy is also sometimes questionable. (The commitment of the national government is discussed below.)

Local political interference in banks has been especially widespread. Branch managers have historically had closer relationships with local government officials than with their bank superiors, and were rewarded more on the basis of loyalty to party and local officials than on the basis of market results.[64] Until very recently, for all intents and purposes, bank branches were under the rule of local officials, who set bank salaries, guaranteed loans, and even were involved in decisions on where the children of bank employees went to school.[65] Local officials guaranteed loans and recommended branch managers, and branches routinely disregarded risk and return to promote public purposes at the direction of party and local government officials. Political interference in lending decisions reportedly has lessened as the government has encouraged banks to adopt international banking practices, but it remains a force.

Problems with Corporate Governance

Corruption continues to be a problem in China, although there have been real improvements here as well. Transparency International, a global corruption-monitoring group, rated China 2.16 in 1995 (a rating beneath 3.0 indicates rampant corruption). In 2005, the ranking improved to 3.4, placing China solidly in the middle in terms of corruption—71st out of 146 countries.[66] Corruption has been especially a problem within the banks, and this must be an important consideration for a foreign bank deciding whether to compete in China through an equity position in a domestic bank and, if so, how to structure any such relationship.

Corruption is considered to be especially prevalent in remote branches and rural institutions: private businesses have complained that in order to borrow from rural banks and credit cooperatives, they are typically forced to bribe lenders with kickbacks of 10 to 15 percent of the loan value.[67] The rural credit cooperatives are reportedly riddled with fraud and controlled by local government officials.

Corruption appears to be a problem not just in rural banks or remote branches but also in the big four banks. The central bank recently reported that 40,000 CCB employees and 18,000 Bank of China employees had been disciplined for misappropriating funds and making unauthorized loans.[68] Additionally, the chairman of CCB was forced to resign in March 2005 for taking bribes. Significantly, CCB had been considered the cleanest of the big four banks. The CBRC also recently announced that it had charged dozens of government officials and bankers at ICBC with attempting to steal almost $1 billion from the bank. Earlier, the CBRC reported that the director of a branch of ICBC had disappeared with $120 million of the bank's money.

The Washington Post reports that there is also significant corruption and cronyism in the four asset management companies created by the government to dispose of the banks' bad loans. The management companies are staffed with many of the same bankers who made the bad loans in the first place; and not surprisingly, the corruption and self-dealing have continued. The government audit office recently reported that it had uncovered 38 cases of embezzlement and fraud at the four companies, involving more than $800 million.[69]

These government disclosures of corruption can be viewed two ways, however. As mentioned earlier, the CBRC is making a strong effort to improve corporate governance at the banks, and many commentators see these public announcements of fraud as positive signs—as proof that

64 *The Economist* (2004b).
65 *The Wall Street Journal* (2004).
66 *The Economist* (2005c).
67 *The Economist* (2004a).
68 Although the big four banks employ a total of 1.4 million people, these numbers are still very significant.
69 *Washington Post* (2005).

auditing and centralized management reforms are detecting fraud and that the government is serious about stopping it.

The level of transparency in businesses, including Chinese banks, is also not good. Of particular concern, the accuracy of bank financial statements is questionable. Although HSBC has taken a minority position in many Chinese banks, its Asia chairman has cautioned that outside investors in Chinese banks need to be extremely careful, for they have found bank financial statements to be unreliable and the banks uncontrollable.[70] Some of the problem may be that the banks themselves do not keep track of operating data. McKinsey reports that one state-owned bank had to spend a month reviewing records and interviewing personnel to arrive at an estimate of its losses and recoveries from defaulted loans.[71] International accounting standards are only used on the small number of publicly listed businesses.

Poor Systems for Ensuring the Return of Capital

China has poor systems[72] to ensure the safe return of capital. Its current laws and foreclosure procedures are ineffective, and creditors have few rights. The judicial system is considered biased and corrupted by local officials and bribery. Enforcement of contracts and of legal judgments is problematic. The credit infrastructure is inadequate, and there are shortages of trained personnel in crucial management areas. The commitment of the government to a market economy is not always clear.

Inadequacy of Bankruptcy Laws. China lacks effective bankruptcy laws and foreclosure procedures. The bankruptcy law enacted in 1986 has been described as incomplete, inconsistent, and opaque.[73] It required criminal fraud investigations in the case of bankrupt companies, and liquidation was the only way to resolve bankruptcy. The law gave creditors few rights and was ineffective in enforcing contractual obligations. With the government acting as shareholder, arbiter, and creditor, there was also an inherent conflict of interest.[74] The government was responsible for approving bankruptcy petitions and appointing liquidators (often local government officials).

A new bankruptcy law has been pending for a decade and is expected to be enacted sometime in 2005. The current version of the proposed law has many of the elements of U.S. law and is expected to conform to WTO requirements. It would apply uniformly to both state-owned and private enterprises, with some exceptions. A court rather than the government would rule on bankruptcy petitions. Liquidation of the assets of the bankrupt entity would be the responsibility of an administrator selected by the court rather than by the government, and the administrator would be supervised by a committee of creditors who would have the right to approach the court to replace the administrator. The current version of the proposed law also recognizes that businesses may fail for a variety of reasons other than criminal mismanagement, and it is similar to Chapter 11 proceedings in U.S. law in that it would allow for corporate reorganization under a bankruptcy court's advisement, with the approval of major creditors. Security interests would be honored (that is, collateral would be sold to satisfy the debt).[75] The draft law provides an exemption period for some state-owned enterprises.

Failure to Enforce Contracts. China has severe problems with the enforcement of contracts and legal judgments. The *China Law and Governance Review* (2004) finds that China's courts lack the "authority and stature" to enforce their decisions, especially when other branches of the government, or government officials, are parties to the case. The *Review* estimates that approximately 30 to 60 percent of legal judgments in China are enforced. Because local protectionism is an important factor in the enforcement of judg-

[70] *The Economist* (2005d).
[71] Desvaux et al. (2004).
[72] The term "systems" is used in a broad sense to include all the mechanisms necessary for the smooth functioning of a capitalistic system, i.e, laws, procedures, infrastructure, and personnel.
[73] Fisher (2005).
[74] Bayron (2005).
[75] Fisher (2005).

ments, this number can drop to 10 percent in areas outside the geographical jurisdiction of the court. The enforcement of legal judgments of all kinds is problematic—whether the issue is compensation for damages, repayment of debt, or enforcement of property rights. Enforcement of a judgment is often a "contest of influence or power."[76]

Commercial and economic judgments are especially difficult to enforce. The *China Law and Governance Review* reports that during the first half of 2003, there were twice as many unexecuted civil and economic judgments in Beijing as executed judgments. Most of these unexecuted judgments were for either bank loan defaults or real estate judgments. A third major category of unexecuted judgments was wages: as of 2003, migrant workers in China were owed approximately $12.5 billion in unpaid wages.

Inadequacy of a Credit Infrastructure and Trained Personnel. An additional systemic problem is the inadequacy of the credit infrastructure and a lack of crucial personnel. As mentioned above, Chinese statistics, including trade statistics, are not considered trustworthy. China also does not have a highly functioning credit culture or highly functioning credit systems. Only the relatively few public businesses use international accounting standards. Systems for uncovering and discouraging fraud are inadequate: external auditing, and internal control systems are undeveloped, and business transparency is not typical. Personal income statements are easily misrepresented, credit-rating services are immature, banks do not have easy access to other banks' data to check on unreported debt or default histories, and the foreclosure process, as described earlier, is in flux.[77] Few channels for risk shifting exist because the government has not permitted the securitization of loans.[78] The markets are illiquid and lack good risk-hedging instruments. Consequently, as mentioned earlier, Chinese banks have begun to experience serious problems with many of the consumer loans they have made, especially auto loans, in a large part due to the inability of the banks to substantiate consumer information and to repossess property.

Regarding personnel, despite the abundance of unskilled labor in many parts of China, unskilled labor is in short supply in the south of the country, and skilled labor is even harder to find. In addition, insufficient local personnel are available for top and middle level management. *The Economist* believes that although for most firms production in China remains cost-effective, a growing shortage of executives requires that substantial time be directed away from sales to human resources, with the result that growth may be slowed. Businesses in China complain about not being able to find personnel with "creativity . . . an aptitude for risk-taking and . . . an ability to manage in everything from human resources and accounting to sales, distribution, branding and project-management."[79]

Uncertainty about the Government's Commitment to Open Competition. It is not always clear how committed the government (even the national government) is to free competition. The Chinese media recently reported a statement by the Vice-Chairman of the CBRC—subsequently disavowed—that after 2006 China might continue to limit the expansion of foreign banks to protect local banks from excessive competition. He stated that the government might restrict foreign banks to the poorer western areas of China and that foreigners might be forbidden to invest in more than two local banks. The Vice-Chairman defended his position by emphasizing that foreign banks held only 3 percent of the assets of the banking system but had a 12 percent share of the market in Shanghai, the business capital of China.[80] As noted, this statement was later disavowed.

[76] *China Law and Governance Review* (2004).
[77] *The Economist* (2004c).
[78] *The Economist* (2005f).
[79] *The Economist* (2005e), 60.
[80] *Financial Times* (2005).

Concluding Remarks

China presents great opportunities as well as great risks—a combination that each foreign bank must weigh for itself. The opportunities include a booming market of 1.3 billion people, many of whom are rising to middle-class status; stagnant competition from the local capital markets and banks; and emergent opportunities for banks in retail, commercial, and investment banking.

The risks are also substantial. There are risks of an overheating economy, of rising protectionism in those countries which buy China's products, of growing economic inequality in a non-democratic society, and problems associated with a rapidly aging population. Additionally, there is a slow moving bureaucracy; government interference in business operations at both the national and the local level; and poor corporate governance, including corruption and lack of transparency. The legal system in China, in its current form, cannot be relied on to protect creditor rights. Moreover, the degree of government commitment to an open market is not always clear.

There have been improvements, however, and when (if) the new bankruptcy law is enacted, banks will have more protection. The Chinese banks in particular, with their massive portfolios of bad loans, should benefit and become both more competitive and more attractive as investments. The business of buying and selling non-performing loans should also benefit. However, enactment of the bankruptcy law alone will not solve the bad loan problem. The law will have to be enforced, and enforcement requires unbiased courts, a government willing to remain neutral, harmonization of this law with other laws, and a cadre of legal and business professionals.

Each foreign bank must decide for itself whether the opportunities of doing business in China outweigh the risks. Banks that have decided to enter this market must also decide whether to enter independently or as a partner with a Chinese bank. Because of a history of government-directed lending, political interference, corruption, and lack of modern management skills and systems, many Chinese banks are badly functioning institutions that are kept alive by government assistance.

The lack of transparency of Chinese banks also makes them uncertain investments. Skepticism about the health of bank portfolios is widespread, even after massive bailouts. Nicholas Lardy, a renowned China expert at the Institute for International Economics, doubts the value of recent bank bailouts, suspecting that these massive infusions of government capital are too little and too soon—a waste of money until basic market reforms are made within the banks. His estimate of the amount of money needed to bail out the entire banking system is approximately 30 percent of China's GDP over the next several years.[81]

Potential investors in China must recognize the corporate governance problems, including corruption and the lack of transparency in Chinese businesses, including the banks, and must negotiate significant protections. They need to be very careful in their investments and seek out relationships that either provide them with substantial control or otherwise limit their risk. As we have seen, the Chinese government and Chinese businesses have shown themselves willing to craft special arrangements that provide some protection for foreign investors. However, competitive forces can obviate even standard protections. For example, in the area of debt underwriting, local Chinese firms have resisted strict covenants typical of junk bond issues, and with the strong demand for Chinese debt, there is concern that a race to the bottom could begin with underwriters agreeing to do away with standard investor protections.[82] Such actions would be dangerous given the conditions described in this article.

[81] *The Economist* (2004b).
[82] Leahy (2005).

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