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## **Post-Subprime Crisis: China Banking and GATS Liberalization**

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30. January 2009

Online at <http://mpa.ub.uni-muenchen.de/13091/>

MPRA Paper No. 13091, posted 31. January 2009 16:52 UTC

# Post-Subprime Crisis: China Banking and GATS Liberalization

M. Ulric Killion\*

## Abstract

The Article first presents a brief history or survey of the some of the earlier problems that associate with China's banking and financial institutions. The Article then addresses specific problems, in the context of the rules, procedures, and practices of the banking and finance sector, which widely range from non-performing loans, to China's money market and interbank lending business. These problems also directly associate with the liberalization of the banking and finance sector of the economy, and the requirements of both the WTO rules and China's WTO Protocol on accession. The Article also briefly explores the US sub-prime mortgage crisis and its contagion effect throughout the world, including the Asian region. In the context of China and the subprime crisis, the Article summarizes some of the problems that associate with China banking and financial institutions, by focusing on the policy implications of the history of banking and finance in China, and what this means in terms of both WTO compliance and greater liberalization of banking and financial institutions, especially pursuant to the WTO GATS, as service industries. All of this, eventually, allows for the presentation of certain conclusions concerning China banking and finance in the new era of a global subprime crisis.

## I. INTRODUCTION

The ending of the Cold War would present new problems in the late 1990s and now, the new millennium. This is because the post-Cold War era (i.e., after 1991) is characteristically presenting itself, though contrary to Samuel P. Huntington (1996) and the Huntingtonians or those adherents still operating on Huntingtonian premises,<sup>1</sup> as one of growing global economic tensions rather than cultural or ideological tensions. These global economic tensions evolved out of fear that at the close of the Cold War, the US would not be able to resolve its trade disputes with Europe and Japan. Given the

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<sup>1</sup> Daniel Chirot, *Returning to Reality: Culture, Modernization, and Various Eastern Europes*, *Transit-Europäische Revue*, Nr. 21/2002. Samuel P. Huntington, *The Clash of Civilizations and the Remaking of World Order* (1996).

perceived threat of the US retreating into economic isolationism because of these unresolved disputes, there was the fear of the formation of three major trading blocs based on the dollar, yen and deutschmark. The January 1, 1994 creation of the North American Free Trade Agreement (“NAFTA”) by Canada, Mexico and the US only heightened these fears. A fear of exclusion from a regional trade agreement, such as a yen bloc, European Community bloc and a dollar bloc in the Americas, drives the foreign diplomacy and international trade policy of many developing countries and economies such as China.

While the problems of the growing trend of regionalism and proliferation of free trade agreements (“FTAs”), which associate with the global trade race to form FTAs, still present a pending crisis and dilemma in terms of free and fair trade, the problems manifested by the US subprime crisis, or that of the US sub-prime mortgage crisis,<sup>2</sup> has now taken center stage. It is a financial crisis that has had a contagion effect because the crisis has spread through the world, as it affects all forms of government and variety of economies. As many earlier anticipated a new world order evolving from the dissipation of cultural or ideological tensions, it is the real reality of economic phenomenon that has taken center stage in the international arena. Thus, the sub-prime crisis is presenting a financial crisis that surpasses all others world financial crises, except, of course, for the earlier Great Depression.

This Article presents a discussion of the US sub-prime crisis and its attendant negative amenities, especially in the context of China and its banking and financial structures or institutions, and the World Trade Organization (“WTO”) liberalization

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<sup>2</sup> Demyanyk, Yuliya S. and Van Hemert, Otto, Understanding the Subprime Mortgage Crisis (December 5, 2008). Available at SSRN: <http://ssrn.com/abstract=1020396>.

requirements, pursuant to the General Agreement on Trade in Services (“GATS”) and General Agreement on Tariffs and Trade (“GATT”). The status of China’s accession to the WTO also involves the issues of China’s WTO commitments pursuant to the WTO Protocol on Accession.<sup>3</sup> While GATS is especially relevant to the banking and financial institutions because they are service industries, commitments within the context of the WTO, the provision of GATT, especially dispute settlement rules, are still relevant.

In Part II, the Article introduces the historical problems of banking and finance in China. This discussion emphasizes problems stemming from structural issues, to policy issues, and to how these problems generally affect both society and the economy. Part III of the Article proceeds to discuss China’s banking crisis, which is a crisis brought on by the contagion effect of the US sub-prime mortgage crisis. Then Part IV essentially continues this discussion, by addressing in a summary form, as the conclusion of this writing, the policy implications of the contagion effect of the US sub-prime crisis. It is a consequence reflecting the history of banking and finance in China, outstanding commitments pursuant to the WTO agreement and relevant rules, and finally, remaining issues such as ideology and nationalism or domestic aspirations.

## **II. HISTORICAL PROBLEMS OF BANKING AND FINANCE**

There are many problems, historically, emanating from China’s underdeveloped financial sector, partially reformed banking industry and vulnerable state-owned enterprises. The banking industry is still in the middle of reforms and its problems affect the economy as a whole. It suffers from deep-rooted problems such as a low degree of

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<sup>3</sup> See WTO Ministerial Conference, Accession of the People's Republic of China: Decision of 10 November 2001, WTO Doc. WT/L/432 (Nov. 23, 2001) (entered into force Dec. 11, 2001).

commercialization, distorted incentives, high ratio of bad loans, government ownership and inefficient management. The estimated size of bad loans, or non-performing loans (“NPLs”), ranges from about 25 to 45 percent of the total loans outstanding for Chinese banks. An elemental problem, which is one of banking market structure and ownership structure, making it difficult to solve these deep-rooted problems is that the four largest state-owned banks in China, namely, the Industrial and Commercial Bank, Agricultural Bank, People’s Bank of China (“PBOC”) and Construction Bank, are in absolute control of the banking industry.<sup>4</sup>

In 1998, China’s central government injected about 27 billion RMB (China currency: Renminbi) of debt-financed money into these banks. In 2004, China announced that it plans to give about 4.5 billion dollars of foreign exchange reserves as an additional capital fund to two of the big four banks. All of which demonstrate that the processes of bank bailouts are familiar to China’s economy, and banking and financial institutions. However, a primary problem of China’s big four banks is that in order to preserve urban employment and growth dynamics during earlier stages of economic reforms, China allowed its state sector to continue expanding output and full employment through easy access to state bank (or the big four banks) credit until about 1995. The consequence was the creation of the NPL problem, which left the big four banks essentially insolvent. Moreover, in terms of China’s banking and financial structure, as one source noted, “So long as the market is contaminated by party politics and state planning, corruption will continue to pollute China’s economic environment.” There are the problems of corrupt

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<sup>4</sup> See Yi Gang, China's Accession to the WTO and the Opening and Reform of Financial Services, in *China: Accession to the WTO and Economic Reform 209* (Wang Mengkui ed., Foreign Language Press Beijing 2002).

officials fleeing oversea with billions of dollars in illicit money, and the prosecution of corrupt officials from various levels of government.

Another problem attributable to the banking and financial structure is growing concern the Chinese economy is overheating. It is a problem of suspected bubbles forming in property, steel, auto production, and power generation clashing against real capacity constraints. China's real problem is over investment, and not inflation, which was a by-product of problems emanating from China's banking industry, especially a government directive that the big four banks increase lending and easier credit. Government policy prompted by the prioritization of economic growth, resulted in an economy producing massive overcapacity, which leads to deflation, more NPLs, and reduction in jobs. In 2004, when nine-tenths of manufactured products were in oversupply, investments in fixed assets still grew by about 30 percent, while contributing to about 47 percent of gross domestic product ("GDP"). According to the International Monetary Fund ("IMF"), three-quarters of China's economic growth actually stems from capital accumulation, but total factor productivity, in measuring overall economic efficiency, rose by only about 2 percent a year in 1995-1999.<sup>5</sup>

China's economic growth, and attendant economic development policies, is economic growth gone astray and resulting in tremendous capital wastage. In the 1980s and 1990s, as one country study found, the economy required about \$2-3 of new investment to produce \$1 of additional economic growth.<sup>6</sup> In a post-WTO China, where economic growth is even more prioritized by the polity, it now generally takes more than

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<sup>5</sup> See cf. Jahangir Aziz and Christoph Duenwald, China's Provincial Growth Dynamics, IMF Working Paper, WP/01/3 (2001),

<sup>6</sup> The Economist, March 18, 2004.

\$4 of new investment to produce \$1 of additional economic growth. It is also a wastefulness that will not sustain continuing economic growth. This magnitude of resulting wasted capital, inevitably, redirected resources from other political economy concerns, such as the plight of the farmers, the mingong, the poor, pension funds, social security and other social welfare concerns.

The ability of China's economy to waste capital on a large magnitude of scale was only possible because of a high Chinese domestic savings rate of about 40 percent of household incomes, and the continuing and uncontrolled exploitation of natural resources. The high domestic savings rate is attributable to the Chinese people needing to provide for themselves because of the lack of adequate social welfare programs. All of which are costs storing up for the future, which will inevitably result in the slow down of economic growth, lest China will find itself drowned in accumulating social debts. Problematic is that neither the continuing waste of capital of this magnitude is sustainable, nor are a continuing domestic savings rate of about 40 percent and depreciation and exploitation of natural resources sustainable.

The large and burdensome NPLs, in conjunction with other problems,<sup>7</sup> are also serving as an impediment to liberalization in banking and financial structures. Reforms in China's banking and finance structure serve as important indicators of both fulfillment of domestic needs and commitments undertaken in the World Trade Organization ("WTO") Protocol on Accession, which addresses both internal liberalization and external liberalization in banking and finance. Market access of foreign banks is a specific WTO

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<sup>7</sup> See cf. Luc Laeven and Fabian Valencia, Systemic Banking Crises: A New Database, IMF Working Paper, WP/08/224 (November 2008), (presenting a fuller discussion of the banking crises, and its condition, containment, and fiscal costs and real effects).

commitment. China is lagging behind on its WTO commitments and purposefully doing so. In terms of reforms and China banking rules, it is a question of whether reforms will result in compliance with, or deviation from, the WTO General Agreement on Trade in Services (“GATS”) (1994), Arts. VI, par. 1, XXIII, par. 3 (i.e., commitments/violation complaint), or seriously impairs expected market access, even if the rule itself is not in conflict with the GATS norms (i.e., non-violation complaint).<sup>8</sup>

This violation complaint versus non-violation complaint dichotomy earlier developed in the 1980s, as the WTO General Agreement on Tariffs and Trade (“GATT”) procedures became increasingly juridical in nature. Consequently, two types of GATT cases evolved, which are the violation cases or the *prima facie* cases, and the non-violation cases charging nullification or impairment. The issue of market access of foreign banks is primarily a problem of the central banking authority promulgating administrative measures that have impaired, if not nullified, reasonable market access to RMB business. Foreign banks could arguably address the latter administrative measure as a WTO GATS, article VI, par. 3, non-violation complaint.

The problem of lagging behind in WTO commitments is best demonstrated by reforms in China’s interbank markets, because they are the cornerstones of financial liberalization. The banking practice of Interbank lending, arguably, corresponding with the commencement of modern reforms (i.e., early 1970s), commences in the mid-1980s. This earlier form of interbank lending would not evolve into a more unified national interbank money market until 1996. After evolving into a unified national interbank

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<sup>8</sup> See John H. Jackson, *The World Trade Organization Constitution and Jurisprudence* 68-69 (Royal Institute of International Affairs, 1998); John H. Jackson, William J. Davey and Alan O. Sykes, *Legal Problems of International Relations* 1162 (St. Paul, MN, 3<sup>rd</sup> ed., 1994).



money market, the money market would generally consist of “the interbank money market, the repo market, and the bill discounting market.” On June 1, 1996, the interbank lending rates experience a degree of liberalization because the upper limits of lending rates, or as now known the China Inter-Bank Offer Rates (CHIBOR), are lifted. In addition, “participants in the interbank money market have grown from 55 in 1996 to 695 at the end of 2005. They include policy banks, commercial banks (domestic as well as foreign), urban and rural credit cooperatives, securities firms etc.”<sup>9</sup>

In most banking systems, the majority of commercial banks funds (i.e., close to about 80 percent) come from bank deposits. Nonetheless, a growing portion of their credit business is being financed through borrowing in money markets such as the interbank markets. Capital markets generally deal with loans and securities of long-term maturities, whereas loans in the money market have an original maturity of one year or less. On November 26, 2002, China’s central bank, the PBOC, proposed the Renminbi Interbank Lending Administrative Measures, which would apply to both China banks and foreign banks offering RMB service. Its novelty was allowing Chinese banks to use intermarket borrowing not only for short-term financing, but also for medium-term financing.<sup>10</sup>

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<sup>9</sup> Wensheng Peng, Hongyi Chen and Weiwei Fan, Interest Rate Structure and Monetary Policy Implementation in Mainland China, China Economic Issues – No. 1/06 (June 2006).

The interest rates prevailing in the inter-bank money market are called China Inter-Bank Offer Rates (CHIBOR), with maturity varying from overnight to four months. In 2005, overnight and seven-day lending accounted for 18% and 70% of the total transactions, while lending with maturity longer than one month accounted for less than 2%.

<sup>10</sup> Michael Imam, The Chinese Interbank Markets, 2004.

The PBOC limited the amount of RMB that banks can borrow from each other to 40 percent of their total RMB liabilities. For the first time since 1995, Chinese banks are being allowed to refinance part of their credit business in the intermarket lending market, rather than relying 100 percent on their own deposits. The problem of foreign banks and market access stems from the 40 percent rule. By the end of 2002, or post-WTO China, there were a reported 53 foreign-funded banks licensed to do RMB business in China. However, ever since foreign banks have conducted local currency lending, funding has been a problem for conducting RMB business. Interbank borrowing became increasingly important for foreign banks, because foreign banks are still facing discriminatory financing rules. They are not allowed to acquire RMB deposits from Chinese customers, their RMB lending is limited to their RMB capital, they are not allowed to issue RMB denominated bonds, and they are not permitted to obtain financing through China's stock market. In the interim, and pending greater liberalization, most foreign banks use interbank financing as their main source of funding RMB assets, or loans to customers.<sup>11</sup>

The problem, as Michael Imam explained, is the 40 percent rule and its protectionist consequence. Interbank borrowing to total RMB liabilities ratios of foreign-funded banks is about 90 percent, which is above the 40 percent limit.<sup>12</sup> Comparatively, China banks continue to have access to Chinese household and corporate RMB savings, all of which totals about US\$1.2 trillion. They do not share the same degree of need to borrow RMB to finance loans. Moreover, foreign banks were earlier not permitted to engage RMB business with Chinese corporations and nationals, which resulted in a denial of access to wealthier customers and sufficient deposits. The consequence is

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<sup>11</sup> Imam, Id.

<sup>12</sup> Id.

protection from foreign banks for Chinese banks, which is at the expense of greater efficiency and greater liberalization of rates until 2006, when China, pursuant to WTO commitments, should have fully opened its banking and finance sector.

### **III. CHINA BANKING CRISIS**

Although being both directly and indirectly affected, like other Asian markets, by the US subprime mortgage crisis, China's response to the subprime mortgage crisis will not be a renewed commitment to outstanding WTO commitments, especially in the banking and finance sector. For instance, in April 2008, according to Xinhua news agency, China's banking authority clarified that the rules governing foreign-funded institutions will remain unchanged. This means that foreign-funded banking and financial institutions will remain in the near future subject to the rule that they can only hold up to a 20 percent stake in Chinese banks. The public announcement corresponds to what was incorrectly thought to be a conflict over whether the ceiling for foreign institutions was 25 percent rather than 20 percent. According to new draft rules, foreign investors should hold at least 25 percent of voting shares in order to control a Chinese-funded financial institution.

As a point of clarification, according to an official from the China Banking Regulatory Commission ("CBRC"), this does not mean that there was a change in the 20 percent shareholding ceiling applicable to individual foreign-funded financial agencies. The CBRC, as Chairman Liu Mingkang announced, has reiterated in the past that foreign-funded financial institutions can hold controlling stakes in non-listed Chinese-funded institutions. However, in the event overseas capital reaches level of at least 25 percent of total shares the original Chinese-funded bank will be subject to treatment as a

foreign-funded institution, thereby subject to different supervision rules. This policy position and attendant rules correspond with earlier 2003 measures, which will still be applicable upon approval of the new draft rules. All of this presents significant challenges to foreign-funded banks. This is because, as of the close of 2007, foreign-funded banks in Mainland China recorded \$171.46 billion in gross assets, which, as the central bank reports, evidences within a one-year period a whopping growth of 47 percent.

The US subprime crisis did affect China's banking and finance industry and other Asian markets. Most experts generally recognize that Asia's 2008 growth and future growth will be constrained by new US woes. This is because Asia's economic growth is likely to suffer constraints due to an unexpected slowdown in the US economy and a potential spillover from the subprime mortgage crisis. For example, and notwithstanding 22 US banks failing in 2008, with banks rushing to conclude new deals as the Wall Street crisis deepens (i.e., Morgan Stanley discussing merger with Wachovia; UK mortgage lender HBOS Plc striking a stock deal with Lloyds TSB that creates a 28 billion pound or \$50 billion mortgage giant), on September 18, 2008, the China Daily reported that at least three large Chinese commercial banks disclosed their exposure to the worsening US financial crisis through bonds issued by investment bank Lehman Brothers, which filed for Chapter 11 (i.e., bankruptcy) protection.

In September 2008, China Merchants Bank, in a statement issued to the Shanghai Stock Exchange, disclosed that it holds \$70 million of Lehman Brothers bonds, of which \$60 million is senior debt and the rest subordinated debt. According to the Xinhua news website, the Industrial and Commercial Bank of China, the country's largest State-

controlled commercial bank by assets, holds \$151 million in bonds issued by, or linked to, Lehman Brothers. As for the PBOC, it was also affected by the failure of Lehman Brothers. This is because the PBOC holds \$75.62 million in bonds issued by the ailing US investment bank. The PBOC also loaned \$53.2 million to Lehman Brothers and its subsidiaries.

An immediate impact of a deepening US financial crisis, plus a gloomy outlook for China's banking sector, was a drop in the prices of Chinese commercial banks' shares. For instance, shares in China Merchants Bank dropped from 9.96 percent to 14.47 RMB a piece. On September 16, 2008, following a 11 percent plummet, China Merchants Bank fell by a total 18.9 percent over two trading days. Three days later, the PBOC dropped a total of 14.8 percent and closes at 2.97 RMB. During the same period, the China Construction Bank plunges 10.09 percent to end at 3.83 RMB, while its "H shares" were also tumbling 8.15 percent to HK\$4.73. An immediate consequence is that the, then, latest 27-basis-point cut to the benchmark lending rate, in addition to the unchanged deposit rate, was expected to squeeze bank earnings by narrowing the interest spread.

Nonetheless, and more importantly, given that China's banking and finance sector is not yet fully opened, as Jing Ulrich, Chairperson of China equities at JP Morgan Securities, recently observed, "the problem of Lehman Brothers is expected to have only an indirect impact on China's financial sector. An individual Chinese bank's exposure to the US financial crisis should be seen in the context of its total assets."<sup>13</sup>

#### **IV. CONCLUSION: POST-SUBPRIME CRISIS**

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<sup>13</sup> Jing Ulrich interview, China Daily, September 18, 2008.

Jing Ulrich's succinct observations, actually, correspond to the history of liberalization and facilitation of trade and investment (TILF) in Mainland China. This also serves as a reminder of China's unaddressed WTO compliance issues. Nicholas R. Lardy's earlier observation still holds true because China remains "in certain respects only shallowly integrated into the world economy,"<sup>14</sup> and count as examples, China's pre-WTO accession opposition, though India-led, to a WTO treaty on foreign investment (i.e., a remnant of "Singapore issues" from 1996 Singapore ministerial conference),<sup>15</sup> and China's, at least partial, blameworthiness for a struggling Doha Development agenda. China's efforts have hindered the advancement of the Doha Development agenda because, since accession to the WTO, China has been unwilling to make significant commitments. This hesitance on the part of Beijing, as observed by Peter Sutherland, generally reflects the view on the mainland that whether China will eventually make needed commitments in the Doha Round is mostly contingent on how other WTO members treat China (i.e., multiple safeguards and antidumping measures).<sup>16</sup> Moreover, there are still unaddressed WTO compliance issues in the banking and finance sector.

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<sup>14</sup> Nicholas R. Lardy, Issues in China's WTO accession, The U.S.-China Security Review Commission, May 9, 2001.

<sup>15</sup> Understanding the WTO - Investment, competition, procurement, simpler procedures, [http://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/bey3\\_e.htm](http://www.wto.org/english/thewto_e/whatis_e/tif_e/bey3_e.htm).

Ministers from WTO member-countries decided at the 1996 Singapore Ministerial Conference to set up three new working groups: on trade and investment, on competition policy, and on transparency in government procurement. They also instructed the WTO Goods Council to look at possible ways of simplifying trade procedures, an issue sometimes known as "trade facilitation". Because the Singapore conference kicked off work in these four subjects, they are sometimes called the 'Singapore issues'.

<sup>16</sup> Peter Sutherland, Correcting Misperceptions, Foreign Affairs (Dec. 2005).

For the same reasons, China, as characterized by one source as an “island in the storm,”<sup>17</sup> will probably translate the US subprime mortgage crisis as only having an indirect rather than direct impact on its banking and finance sector. China’s polity will translate the US subprime mortgage crisis as only having an indirect rather than direct impact on its banking and finance sector. Notwithstanding marginalization of the impact of the US subprime mortgage crisis, the history and actions of China’s polity demonstrate that it will continue to challenge the WTO rules and aspirations embodied in the WTO, especially as the embodiment of Western dialectic visions of a new world order. All of this ultimately results in business as usual for China banking and finance, in the short and long run. As previously mentioned, for a socialist-political polity pursuing capitalist-economic policy, the processes of bank bailouts are familiar to China’s economy, and banking and financial institutions.

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<sup>17</sup> Lo Chi, Credit crisis, Asian style: a top Hong Kong analyst sets the stage, *The International Economy* (Fall 2008).