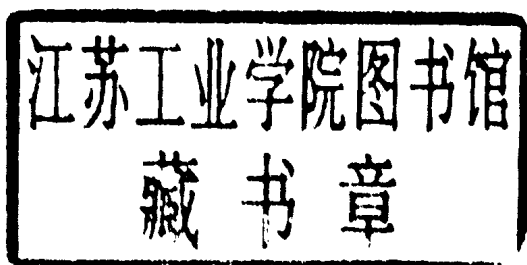


Foreign Participation in China's Banking and Securities Markets

Francis A. Lees and K. Thomas Liaw

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Abbreviations

ABB	Asea Brown Boveri
ABC	Agricultural Bank of China
ADR	American depository receipt
ADS	American depository share
BOC	Bank of China
BOO	Build-own-operate
BOOT	Build-own-operate-transfer
BOT	Build-operate-transfer
CFETC	China Foreign-Exchange Trading Center
CFETS	China Foreign-Exchange Trading System
CIB	China Investment Bank
CITIC	China International Trust and Investment Corporation
CMB	China Merchants Bank
COLC	China Oriental Leasing Company
CP	Charoen Pokphand
CRE	China Resources Enterprise
EJV	Equity joint venture
FDI	Foreign direct investment
FEC	Foreign-Exchange Certificate
FECL	Foreign Economic Contract Law

FERC	Foreign-Exchange Registration Certificate
FIB	Fujian Industrial Bank
FTC	Foreign trade corporation
GATT	General Agreement on Tariffs and Trade
GDB	Guangdong Development Bank
GDP	Gross domestic product
GDS	Global depository share
GNP	Gross national product
GPF	Global Privatization Fund
HKMA	Hong Kong Monetary Authority
ICBC	Industrial and Commercial Bank of China
IMF	International Monetary Fund
KMT	Kuomintang
kV	Kilovolts
MIGA	Multilateral Investment Guarantee Agency
MOFERT	Ministry of Foreign Economic Relations and Trade
MOFTEC	Ministry of Foreign Trade and Economic Cooperation
MW	Megawatts
OECD	Organization for Economic Cooperation and Development
OTC	Over-the-counter
PBOC	People's Bank of China
PCBC	People's Construction Bank of China
PRC	People's Republic of China
R&D	Research and development
RCC	Rural credit cooperative
SAEC	State Administration of Exchange Control
SAIC	State Administration of Industry and Commerce
SDB	Shenzhen Development Bank
SEIC	State Energy Investment Corporation
SEZ	Special economic zone
SOE	State-owned enterprise
SPC	State Planning Commission
SSE	Shanghai Stock Exchange
SSR	Shanghai Securities Regulations
UCC	Urban credit cooperative

VAT	Value-added tax
VW	Volkswagen
WFOE	Wholly foreign-owned enterprise
WTO	World Trade Organization

Foreign Participation in China's Banking and Securities Markets

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Economic Environment and Reform

This chapter provides an overview of the economic environment and structural reforms now taking place in the People's Republic. Each year, foreign participants can make loan and investment commitments in China in an increasingly more flexible and hospitable business and regulatory environment. China is building an institutional system and more market-oriented economy year by year. In this chapter, we outline some of the more significant reforms and trends affecting the foreign participant. These changes create opportunities. Anyone seeking to exploit such opportunities must be aware of the changing regulatory environment, of problems likely to be encountered, and of the strategic objectives of the government. We hope this chapter is instructive regarding these issues.

MACROECONOMIC ENVIRONMENT

Since initiation of the economic opening and reform process in 1979, the People's Republic of China has achieved an impressive performance. Structural adjustments have been achieved, paralleled by a high rate of industrial expansion. Over a fifteen-year period ending in 1994, real output has been increasing at 9 percent annually.

These impressive gains are associated with large productivity gains for labor and capital. In turn, these gains translate into improvements in real income levels, living standards, and material welfare. Economic units are much freer to make decisions based on market trends and conditions. The

rigidities of the former central planning system have been reduced if not entirely eliminated. The PRC now boasts a large nonstate industrial sector which has become larger than the state enterprise sector. The private sector (including cooperatives) now accounts for two-thirds of GDP.

These changes could not have been completed without opening the economy of China to the rest of the world through liberalized trade and investment. As a result of this opening, many sectors and regions of China

Table 1.1

Selected Macroeconomic Indicators (annual percent change, unless otherwise specified)

	<u>1980</u>	<u>1981</u>	<u>1982</u>	<u>1983</u>	<u>1984</u>	<u>1985</u>	<u>1986</u>
RGNP	7.9	4.4	8.8	10.4	14.7	12.8	8.1
RGIO	9.3	4.3	7.8	11.2	16.3	21.4	11.7
RGFI	2.9	-12.5	28.0	14.7	22.7	27.3	13.3
Retail prices							
AVE	6.0	2.4	1.9	1.5	2.8	8.8	6.0
END	22.2	2.6	0.1	3.7	4.8	10.7	6.2
BM	24.1	19.7	13.1	19.2	42.4	17.1	29.3
DC	22.3	13.1	11.2	12.8	31.4	31.3	34.1
NDA							33.9
ME	33.7	20.5	-4.0	-2.0	15.4	5.0	2.6
MI	24.8	12.6	-16.4	-10.9	27.6	60.0	-8.7
TB	1.9	NA	3.0	0.8	-1.3	-14.8	-12.0
	(in percentage of GNP)						
CAB	0.3	0.9	2.1	1.5	0.8	-4.0	-2.6
OBB	-3.3	-1.3	-1.4	-1.7	-1.5	-0.5	-2.0
Rev	29.4	29.0	27.2	27.4	26.4	26.6	25.1
Exp	32.7	30.3	28.6	29.1	27.9	27.1	27.1

Source: *China Statistical Yearbook*, United Nations, 1992; and estimates by Chinese economists and officials.

Notes: RGNP, real gross national product; RGIO, real gross industrial output; RGFI, real gross fixed investment; AVE, average retail prices of period; END, retail prices at end of period; BM, broad money; DC, domestic credit; NDA, net domestic assets; ME, merchandise exports, percent change in U.S. dollar terms; MI, merchandise imports, percent change in U.S. dollar terms; TB, trade balance, in billions of U.S. dollars; CAB, currency account balance; OBB, overall budgetary balance; OBB-Rev, revenue; OBB-Exp, expenditure; NA, not available.

have become more closely integrated with the world economy. China's ratio of trade to GDP has risen significantly, and the country accounts for a much larger share of world exports and imports. While these achievements are impressive, many problems remain. One is the need for a more effective institutional framework through which the economy can be managed. This institutional framework currently requires greater independence for the central bank (PBOC), an improved fiscal policy framework, more effi-

<u>1987</u>	<u>1988</u>	<u>1989</u>	<u>1990</u>	<u>1991</u>	<u>1992</u>	<u>1993</u>
10.9	11.3	4.4	4.1	7.7	13.0	13.4
17.7	20.8	8.5	7.8	14.5	22.0	21.1
14.7	10.4	-15.5	1.2	18.8	28.2	22.0
7.3	18.6	17.8	2.1	2.9	5.3	13.0
9.1	26.7	6.4	2.2	4.0	6.7	17.6
13.2	21.0	18.4	28.0	26.4	31.3	24.0
22.3	18.9	17.1	23.7	20.2	22.8	22.4
21.5	20.7	18.3	24.1	25.0	32.7	25.4
34.9	18.2	5.3	19.2	17.8	18.6	8.0
4.3	27.4	5.3	-13.3	22.3	26.2	29.0
-3.8	-7.7	-6.6	8.7	8.1	4.4	-12.2
0.1	-1.0	-1.7	3.9	3.8	1.8	-2.5
-2.2	-2.4	-2.3	-2.1	-2.5	-2.5	-2.1
22.8	20.0	20.4	20.1	18.1	16.3	15.4
25.0	22.4	22.7	22.1	20.5	18.9	17.5

cient tax administration, a larger financial market system through which monetary policy measures can be transmitted, and more effective techniques for the control and regulation of investment expenditure. These areas of need are addressed in close detail in this chapter.

The lack of an effective institutional framework has left the Chinese economy more exposed to stop-go cycles of macroeconomic instability. At times, administrative measures aimed at stabilization of the economy have imposed abrupt and excessive restraint on the economy.¹

The foreign participant in China should expect high, above-average macroeconomic growth. However, this may be subject to periodic interruption. For example, in the period 1980–93 such interruptions took place in 1981, 1985–86, and 1989–90. These interruptions took the form of slower expansion in real GNP. In 1981, real GNP growth was only 4.4 percent, in 1986 it was 8.1 percent, in 1989 it was 4.4 percent, and in 1990 it was 4.1 percent (Table 1.1). In the following sections, we examine the circumstances of such slowdowns and how the foreign participant might prepare for these recessions.

CHINA'S ECONOMIC PERFORMANCE

China has become a more attractive country for the foreign participant both because of favorable economic performance and an improving economic and financial structure and because it is a country that has opened itself to greater international contacts and competition. In the following sections, we examine these changes from the perspective of the foreign participant.

Growth and Cycle

Over the period 1980–93, the PRC attained a 9.3 percent average annual increase in real GNP. In the same period, average annual growth in real industrial output was 13.7 percent (see Table 1.1). The expansion in merchandise exports was even more impressive, in some years exceeding 30 percent.

This impressive growth was accompanied by some instability. Like any country industrializing rapidly, China experienced periodic interruptions in economic expansion. These cyclical interruptions show up in a more pronounced way in fixed investment (Table 1.1, Line 3), merchandise exports (Table 1.1, Line 8), and to a lesser extent, in changes in retail prices (Table 1.1, Lines 4 and 5). They manifest themselves with slight lag behind other series in merchandise imports (Table 1.1, Line 9).

The most recent cycle began in 1992 when Deng Xiaoping called on the nation to accelerate growth and vigorously pursue the policy of reforming and opening the economy. This was interpreted by government officials at the local level as a mandate for faster growth. As a result, a boom followed

in fixed investment, and the economy quickly became subject to inflated credit and prices. With growing concern over intense demand pressures and excess speculation in financial markets, the authorities introduced a package of stabilization measures in July 1993, called the "Sixteen-Point Program."

At this time, the authorities intensified their plans to develop comprehensive economic reforms. These reforms are intended to transform the Chinese economy into a more fully market-based system. The new phase of economic reforms began in 1994, and they are discussed in the section on economic reform later in this chapter.

Foreign participants may expect the growth and cycle pattern to continue. It takes the form of money and credit growth and investment expansion attaining levels that are not sustainable in the long run. When this occurs, it is necessary to slow down the system to avoid even greater distortions in prices and financial burden associated with high levels of enterprise investment activity. Periods in which unsustainable levels of money and credit growth took place include 1980, 1984, 1986, and 1990–1991–1992–1993. Periods in which unsustainable levels of investment expansion took place include 1982, 1985, and 1992–93 (see Table 1.1). These economic series, among others, are important clues to the growth and cycle pattern. They should be analyzed carefully to anticipate changes in basic economic conditions.

Changing Structure

Since China's economic opening, the country has experienced a changing structure that not only operates across many aspects of economic and political life but also contains geographic aspects. Here we focus on five structural changes:

1. Regional aspect of opening
2. Monetization of economic activity
3. Shift toward private-sector production
4. Corporatization
5. Growing importance of foreign trade

These structural changes are important since in many ways they affect the opportunities available to foreign participants.

The open-door policy pursued by China after 1978 is significant in that it reversed the previous bias against the coastal areas.² These areas could best take advantage of and benefit from international trade opportunities. More important, the government promoted accelerated development of specified coastal locations. The government was interested in establishing investment incentives in special trading zones and coastal cities that would be given authority to set their own guidelines and regulations concerning foreign-investment enterprises. While the special economic zones (SEZs) in China

have not been domains of laissez-faire policies, they have enjoyed far fewer restrictions and more liberal treatment.

The SEZs and open coastal cities have been able to cut through red tape and offer investment incentives such as tax exemptions. This has caused other municipalities and regions in China to demand the power to provide similar liberal treatment vis-à-vis foreign business firms. Consequently, much of coastal China has been favorably influenced, directly and indirectly, by the dynamics of high investment and foreign trade growth.

Economic activity in China has experienced an upward shift in the degree of monetization. Over the period 1980–92, the ratio of money (broadly defined) to GDP increased from 25.5 percent to 66.6 percent.³ Only relatively high income-developing countries (South Korea, Greece, and Malaysia) have equivalent ratios of money to GDP. The strong upward shift reflects the transition toward a more market-oriented system in which money-based transactions are becoming a dominant factor. In this system, prices are rising, and money wages are required to cover ordinary day-to-day living expenses. Government subsidies to consumers are giving way to increased discretionary spending. Suppliers of consumer goods are competing increasingly to attract discretionary expenditures.

The monetization process signals higher growth of bank assets and deposits. Financial asset growth implies the need for diversification of financial asset types and the growth of nonbank financial institutions. This translates into opportunities for foreign participants in banking, financial institutions, and securities markets.

A third structural change is the shift toward private-sector production. By 1993, state enterprises were accounting for less than half of industrial output. Much of the private-sector production displacing state enterprises is partially owned and controlled by foreign joint ventures. In the earliest stages of the opening, overseas Chinese accounted for a major share of the inward investment flow; but in later years, American, European, and Japanese multinational companies have played a more important role as foreign direct investors in Chinese manufacturing and commercial enterprises.

A large and dynamic private sector affords foreign participants greater opportunities to operate business and financial ventures with less fear of being singled out because of their private-sector orientation.

A fourth structural change is the corporatization of state enterprises, a process that often is the first step toward transforming state-owned enterprises into privately owned and managed business entities. Corporatization in China aims to (1) create a more flexible organizational format, (2) modernize a formerly inefficient enterprise, and (3) prepare an enterprise to adopt accounting and financial reporting standards required for stock exchange listing in Hong Kong or elsewhere.

A fifth structural change is the growing importance of trade. Based on World Bank data, China's exports increased from 8 percent of GDP in 1982

to 17 percent in 1992.⁴ While over the period 1982–92 China's GDP growth was impressive, export growth was much higher.⁵ In 1992, China was the world's tenth ranking exporter.

The commodity composition of China's trade also experienced a structural change. As China's market-reform strategy progressed, the commodity composition of exports was transformed. During the 1980s there was a shift away from reliance on petroleum exports toward export of products in which China enjoys a comparative advantage.⁶ The share of manufactured goods increased to become a dominant component. This includes labor intensive manufactures such as apparel, textiles, footwear, toys, and sporting goods. Exports of electrical equipment increased relative to other exports, including telecommunications equipment, television sets, radio receivers, washing machines, and refrigerators.

Role of Foreign Trade and Investment

Foreign Trade. Since the opening in 1979, the role of external trade in China's economy has increased impressively. Over the past decade and a half, China's foreign-trade policy has been to promote exports to gain foreign exchange. Trade policy has been relatively restrictive toward imports.

Overall foreign trade has grown at approximately 25 percent annually in the period 1980–92. Total trade has increased in importance to China's GNP, and China's share of world trade has risen sharply. In 1980, China's exports represented 0.7 percent of world exports. By 1993, China's exports were 2.5 percent of world exports. In 1992, China's total exports plus imports of \$165 billion represented 32.7 percent of GNP, ranking China tenth among the world trading powers.⁷

The composition of exports and imports has changed markedly. Previously we described the shift in export composition toward higher-value manufactured goods including consumer electronics items. Similarly, the composition of imports has changed. The share of food items and other primary products declined sharply. On the other hand the share of capital goods (machinery and transportation equipment) increased from 25 percent (in 1980) to 40 percent (in 1992) of total imports.⁸ Consumer goods remained under 5 percent of total imports in the period 1980–92.

In 1979–80, China's import structure was subject to detailed control and management. Imports were an important part of the economic plan to assure adequate supplies of food, raw materials, and other goods. Large quantities of imports filled the plan-oriented supply gap. Relative prices were not a major factor in determining planned imports. Since 1979–80, a declining share of imports has been covered under the economic plan.

China's trade flows are volatile. This is especially true on the import side and is applicable to both import values and import volumes. The volatility is associated with macroeconomic cycles. During economic upswings, imports