The Liberalisation of Chinese Financial Markets

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Author: Vilem Semerak

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Executive Summary

Despite China’s rapid development and modernisation, several aspects of its financial system remain unchanged: (i) the system remains centered around banks, (ii) the Communist Party still uses the sector as one channel for achieving control over the economy, and (iii) banks are still seen by many as a way to support state-owned enterprises and local economic interests. Previous reform experience shows that this hidden role of the financial sector remains crucial and giving up this valuable instrument of control is difficult. However, a genuine need for full reform exists. The current system has negative effects on both welfare and the structure of the economy, and it also inhibits China’s ability to shift focus towards domestic demand and cope with macroeconomic imbalances.

Any reforms to the Chinese market are likely to be slow, and there will be faster changes in the external appearance of the system than in its real internal mechanisms. The resulting system is likely to preserve a strong reliance on banking, a dominant role for domestic financial institutions, and at least some indirect control of the official structures that deal with the allocation of capital. European financial business working in China will find it easier to succeed in sectors that are less directly linked to state control (e.g. consumer lending) and in operations linked to the activities of other European companies in the Chinese market.
Main Points

- While the Chinese system has experienced rapid modernisation and expansion, many of its features still differ from those of a pure market economy.
- The Chinese financial system is, and will remain, bank-centred. Both the stock market and bond market will play a secondary role in the external financing of companies.
- Banks have also played an important role in the portfolio of instruments which the Party uses in both official policies and the individual agendas of its influential members.
- There is empirical evidence supporting the claims that the current financial system has distortive effects and influences that are negative to both the welfare of Chinese citizens and the structure of the Chinese economy.
- While the need for reform definitely exists and the proposals of many Chinese officials are genuine and well-intentioned, real progress is likely to be constrained by power-related factors and is likely to be slow.
- In spite of gradual opening-up and internationalisation, the Chinese banking market is likely to remain dominated by domestic financial groups.
- Opening-up will occur faster in sectors which are less relevant for control over economy.
- European banks and other financial institutions may find interesting opportunities in China in innovative products, especially in services for European companies in the Chinese market.
- Chinese banks will be more active abroad (including the EU), especially if the liberalisation of Chinese financial market continues.
Introduction

Proper evaluation of the current and future development of the financial architecture of the People’s Republic of China (PRC)\(^1\) is of utmost importance for European policy-makers and companies. This is both because of its relevance for the future growth and macroeconomic stability of the PRC, as well as what it reveals about the internal political dynamics of the country and the ambitions of its elites, especially during the current period of transition to new generation of leaders (expected to take place in late-2012).

This paper focuses on four main questions, mainly from the perspective of the banking sector: what are the prospects for further deregulation and financial liberalisation in the PRC; how is liberalisation related to macroeconomic efficiency and stability of the country; how is the process related to the capital (financial) account opening of the country; and what is the relevance of this for European institutions. By financial deregulation and liberalisation we mean greater access for foreign (or new) financial institutions in the Chinese financial markets, as well as changes in the regulation of intermediation channels (e.g. caps on interest rates for depositors) and influence of various administrative bodies on the allocation of capital.

1. Financial Architecture of the PRC

Theorists analysing empirical data often find that ‘things are not what they seem to be’. This cliché is very true for the Chinese financial system which, on the surface, appears to resemble the systems of many developed market economies but, below the surface, has internal logic and dynamics that remain very idiosyncratic.

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\(^1\) This paper does not cover Hong Kong, Macau and their financial markets.
1.1 Chinese Financial Architecture: External Appearance

The Chinese financial system has undergone dramatic changes since 1978 – both in terms of structure and regulation, and in terms of the sophistication and size of its main institutions. Having started with a model inspired by the Soviet Union’s central planning system, which had a very passive and subsidiary role for financial markets (which only existed in the form of banking intermediation), since 1978 the PRC has introduced a traditional banking system\(^2\), opened official stock markets and reintroduced bonds. While most traditional channels of direct financing and intermediation are present, the resulting system still heavily relies on banking intermediation. The dominance of the banking sector in external financing is nothing unusual per se (it is common even in developed countries like Germany and Japan), moreover both China’s stock market and bond market appear to be very dynamic and receive a lot of attention at home and abroad.

Chinese banks have managed to dominate the rankings of the world’s largest banks over the past 15 years. In 1999, there were no Chinese banks listed among the top 20 world banks by market capitalisation, but by 2009 China had 5 banks listed in the top 20, three of which took the top three positions (Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC)). Results for late 2011/early 2012 show a similar pattern: 4 Chinese banks are in the global top 20 by capitalisation with ICBC and CCB ranked in first and second place, respectively. Their position is slightly weaker in terms of total assets, where ICBC only ranks eighth, but the PRC still has four institutions in the global top 20. No other emerging country in history has achieved anything similar.

The Chinese banking system also seems to be highly liquid and stable – although it needed assistance with its non-performing loans (NPLs) in the 1990s, recent official statistics show that both the volume and share of NPLs had declined during 2006-2010 and profits were increasing. Chinese banks accounted for 29% of global profits in the banking industry in 2011. Chinese banking appears very colourful thanks to a high number of bank and bank-like institutions (top 3 wholly state-owned banks, 5 equitised commercial banks\(^3\), 92 local banks under control of local administrations, 12 Chinese joint-stock banks, a fully private bank), which also includes 185 foreign banks from 45 countries. It also successfully keeps up

\(^2\) Instead of the monobank typical for centrally-planned economies.

\(^3\) Former state banks transformed into joint-stock companies, but controlled by the government.
with modern trends – ranging from the modernisation of the regulatory environment (Basel III) to mobile banking or even microfinance-oriented institutions in rural regions.

China’s equity market(s)\(^4\) also appears to be a success story. Since the inception of stock markets in Shenzhen and Shanghai in 1990, the extent of stock trading reached and then exceeded the typical dimensions for the most developed market economies, much higher than in European transition economies.\(^5\) Outside of China’s two stock markets, many joint-stock companies are also listed in Hong Kong. Initial public offerings (IPOs) of shares, especially for state-owned enterprises (SOEs), are popular and occur much more frequently than in transition countries; futures trading (including stock index future trading) and short selling exist and authorities (namely, the China Securities Regulatory Commission) have tried to regulate the market to fight against insider trading. Foreign investors have been allowed to invest in A-shares within the Qualified Foreign Institutional Program (QFII) since 2002. In short, the symbols of the market economy seem to be alive and well-established in China.

The Chinese bond market reemerged with the issuance of government bonds in 1981 and currently consists of the interbank bond market and the exchange market. Its role has been increasing, even though its total role in external financing remains low (because most of the traded bonds are government bonds and central bank notes). However, innovations and growth of the market continue - in June 2012, for example, China opened a high-yield junk bond market. Bonds are important for the possibility of a more intensive international role for Chinese currency, in particular the so-called ‘Dim Sum’ bonds (RMB denominated bonds issued offshore) which were introduced in 2007. The issuance of these bonds reached around 10 billion Euros in 2011.

The financial markets are regulated and supervised in a way that is reminiscent of standard market economies. The China Banking Regulatory Commission (CBRC), China Securities Regulatory Commission (CSRC), and China Insurance Regulatory Commission (CIRC) are each responsible for their respective fields. Chinese authorities and officials also publicly declared the need for further change and opening repeatedly, even in official documents such as the 12\(^{th}\) Five Year Programme.

\(^4\) China has two stock exchanges (Shenzhen and Shanghai), some shares are also listed in Hong Kong.

\(^5\) The total value of shares traded in 2010 amounted to 135.5% of GDP, which the second highest such ratio after the USA. We get the same ranking for total value of shares traded. See charts I and chart II in the appendix for details.
1.2 Capital Market in PRC: Below the Surface

The institutions that we tend to believe epitomise market forces seem to work slightly differently in China. Stock markets and bond markets are very good examples of this paradox. Important Chinese companies remain under the control of the Communist Party of China (CPC), which means that their control is never really traded in stock markets, despite the fact that their shares are tradable. Buyers of shares are thus allowed to ‘contribute’ their funds during an IPO and can participate in the profits. The role of foreign investors under the QFII regime (relevant for investing in A-shares) remains limited – while their quota was increased to 80 billion USD (EUR 65 billion) in April 2012, their share remains below 0.8% of market capitalisation.

Even the formation of the Shenzhen and Shanghai stock markets can be viewed as an attempt to channel market forces under supervision of the centre, rather than real decentralisation. Bond markets are fairly unique too – most of the bonds are held until maturity and are never really traded. Most importantly, state controlled entities are often found on both sides of the transaction.

Also banking remains fairly specific. Firstly, the state keeps significant direct control (more than 90% of banking sector assets are majority state-owned). Secondly, their liquidity and financial stability is achieved by excessive regulation of the banking market in the form of ceilings on interest rates for deposits and floors on rates for borrowers. The interest rate ceilings together with the lack of alternative forms of investment mean that Chinese depositors’ high savings are used as a convenient liquidity cushion for the banking sector. Most Chinese depositors have no other option than to entrust their money to banks at a low (and mostly negative in real terms) interest rate. A recent analysis by the Economist aptly characterises the banks as ‘battery hens force-fed with deposits’.

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6 The control goes much deeper than is typical for state owned enterprises in the Europe. The state not only supervises the companies via the State-owned Assets Supervision and Administration Commission (SASAC), but the Organization Department of the Communist Party of China Central Committee also has direct control over appointments to top positions in companies.

7 Most Chinese depositors have no other option than to entrust their money to banks at a low (and mostly negative in real terms) interest rate. A recent analysis by the Economist aptly characterises the banks as ‘battery hens force-fed with deposits’.
The CPC thus preserves a substantial degree of control over the financial system. While some experts consider this to be an omission or relic of the past which will disappear with further reforms, others find this feature a part of a deliberate design serving several purposes. Most importantly, it provides the authorities with a comfortable instrument for direct economic interventions, such as the 2009 credit boom; and with guaranteed and cheap financing to preferred companies and projects. Very importantly, this type of governance can act as a vital stabilising mechanism with respect to dealing with debt problems of e.g. provincial governments. Negotiating and arranging debt roll-overs or write-offs is therefore much easier and gives the authorities power that their European counterparts do not have. Sacrificing these powers for the sake of long run efficiency is quite a challenging decision in the current turbulent environment.

While the current system is thus very different from traditional centrally-planned finance in its external appearance, its function has more similarities. In spite of its profits and growth in assets, banking in particular remains part of the system that is assumed to play an accommodative role – providing finance for projects which central or local (depending on the balance of power) authorities consider important and guaranteeing a substantial degree of softness to the budget constraints of public and semi-public institutions.

2. Determinants of the Financial Architecture in the PRC

The financial system of the PRC has been formed by seven key factors (see sections 2.1-2.7) in recent years. Given the path-dependency that is typical for large economic and political systems, most are likely to remain stable in the near future. Together they imply that: (i) the Chinese financial system needs further reform and opening up, (ii) many officials are aware of this necessity, (iii) despite reform, the

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8 And less visible as well. The financing institutions are much less likely to protest openly than e.g. in Greece, where even the pension fund of the ministry of finance was attempting to block the 'haircut' (debt reduction) in March 2012.

9 Shih (2008) even claims that “Although Western models of financial organization have affected the configurations of some key institutions such as the central bank and the stock market, the state continues to have the same enormous leverage over the distribution of capital that it had in 1978”.

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Chinese system is likely to remain different from the financial systems of developed countries, and (iv) consideration should be given to factors that could slow down and dilute the necessary steps for reform.

2.1 The Character of Chinese Economy

The Chinese economy is still that of a less developed country and faces significant problems with information asymmetries and a large share of the population without extensive experience of financial markets. In this environment, economies of scale in information acquisition and processing are important and lead to reliance on more indirect and concentrated forms of financial intermediation. Consequently, the dominant role of banking remains likely to prevail. There is nothing wrong about this per se – bank intermediation has the potential to be more efficient in this kind of environment.

However, China has also been described as ‘over-banked’ because of the sector’s unusually high share of credits/assets to GDP. It would therefore be unreasonable to expect expansion of the whole sector at rates that significantly exceed the growth of the country’s nominal output; instead we are likely to see a gradual structural change and modernisation in this sector.

2.2 WTO Membership and the Opening of the Chinese Market

Access to the Chinese market was very selective before its accession to the World Trade Organization (WTO). China basically only allowed foreign banks to conduct foreign currency business in selected cities.\(^\text{10}\) When entering the WTO in 2001, China committed to fully opening its banking sector to foreign competition by 2006. This pledge has played a very positive role, as it seems to have motivated China to assist its four large state-owned banks with their huge stock of NPLs accumulated during the 1990s and recapitalise them in a relatively standard way.

\(^\text{10}\) Currency services in RMB were permitted on an even more selective and experimental basis.
However, market excess remains asymmetric and foreign banks still face a number of requirements which do not apply equally to foreign and domestic banks.\textsuperscript{11} The market share of foreign banks remains low (about 2%) and their ability to attract clients is limited as they are required to maintain a 75% ratio between loans and deposits while being subject to the same interest rate regulation as domestic banks (i.e. they cannot offer higher returns to depositors). There is also a three-year waiting period to which foreign bank branches are subject before being eligible to submit their application for the RMB license. It is also difficult for foreign banks to attract deposits because of their significantly less widespread branch network.

2.3 Changes in Banking Regulation in Other Countries (Basel III)

In sharp contrast to increasingly negative opinions on the attractiveness of foreign financial systems, the PRC seems to be one of the most enthusiastic supporters of the Basel III regulation. Although the China Banking and Regulatory Commission (CBRC) has been granted some flexibility in this respect, these steps are expected to improve the transparency and stability of Chinese banking. As a by-product, the environment and regulatory requirements could become better for dealing with foreign institutions.

2.4 Long Run Efficiency Considerations

There is a vast macroeconomic literature that focuses on the efficiency of financial institutions (especially with respect to the allocation of capital and growth). Some theoretical models suggest that impediments to the efficiency of allocation lead to biased growth, meaning that the economy is likely to achieve suboptimal results. Similar outcomes can be derived from microeconomic models that consider the effects of soft budget constraints. This may result in lower growth, waste in the form of investing scarce capital into sectors with low or no returns, and redistribution of wealth. If these theoretical

\textsuperscript{11} More details can be found e.g. in the Position Paper of the European Union Chamber of Commerce in China. The state control over banking and the ability to decide on financing and its price influences relative position of foreign and Chinese companies not only in the financial sector but also on other markets.
insights are true, how can we reconcile the lack of motive for efficient behaviour observed with the fast growth of the Chinese economy?

A substantial part of China’s economic growth has been based on total factor productivity (TFP) improvements. The ability to generate high TFP growth differentiates the Chinese case from traditional centrally-planned economies and suggests that Chinese growth could, at least to some extent, be sustainable even with distorted financial markets. However, there is a price to pay, as impressive growth rates require even more impressive investment ratios. Some commentators suggest that China would have been able to generate equally impressive growth with a much lower rate of investment; a significant proportion of investment made between 1978 and 2008 was in the less efficient state sector, which has a rate of return close to zero. The country’s inhabitants thus paid a fairly high price for the inefficiency of financial institutions; households (especially those without access to forms of saving outside of bank accounts with capped interest rates) have been subsidising growth. Inefficiencies in the financial system have therefore restricted China’s ability to rely on domestic demand and increased its dependence on external demand, as well as its reliance on the industrial sector at the expense of services.

Three main factors have so far prevented greater adverse effects on the growth and stability of the Chinese economy. Firstly, China has started from a very low base, i.e. from a situation where many kinds of investment could lead to relatively high positive returns. Consequently, errors in allocation might have had less pronounced macroeconomic effects. Secondly, the Chinese economy was in the process of overcoming a development gap - achieving fast growth is easier when a country is just returning to its potential (and when efficiency can be increased with the help of imported technologies). Finally, suppressed demand at home has been overshadowed by China’s reliance on external demand. All of these factors are likely to be less reliable in the coming years. Consequently, the continuation of financial sector reform is necessary if China is to sustain fast and balanced growth in future.
2.5 Short Run Economic Factors

The current structure of the financial sector and its regulation are also indirectly responsible for both real estate bubbles\(^\text{12}\) and for the occasional outbursts of inflation seen in recent years. Further liberalisation should bring additional benefits in the form of more balanced and stable development.

However, while Chinese banking as it currently stands is not ideal, it can appear as ‘good enough’ for a non-economist decision-maker especially when official numbers are compared with the troubles faced by many developed countries in the Economic and Monetary Union (EMU).

There are two more additional reasons which can dilute the determination for further reform:

- The effects of the build-up of debt of provincial governments since 2009. While this development vividly demonstrates the weaknesses\(^\text{13}\) of relying on the financial system as the main instrument of control and stimulation (and as such it theoretically should support the need for reform), the risks\(^\text{14}\) related to the current exposure can convince the Party to prefer the status quo. Having control over both debtors and creditors substantially increases the chances that the debt problem can be contained without the escalation faced by several EMU countries.\(^\text{15}\)

- The financial crisis also dramatically reduced the attractiveness of both US and European financial systems and reinforced the self-confidence of Chinese political elites. The ‘don’t show me any failed models’ mentality has therefore become a key factor which could undermine the efforts of foreign pressure for further reforms.

\(^{12}\) Real estate investment (buying a second or third apartment) is viewed by Chinese citizens as one of the few ways how to get better returns on their wealth than the regulated rates on deposits and protect its value from inflation.

\(^{13}\) According to the IMF, if further stimulus is considered, it should be a standard fiscal stimulus instead of a stimulus which would further increase the exposure of the financial sector.

\(^{14}\) It has been pointed out that some of the provincial governments will be unable to meet their obligations, which means that a sharp increase in the share of NPLs is expected. This can be further exacerbated by the current slowdown of Chinese economy and by the dependence on exports to the Eurozone.

\(^{15}\) This is the main reason, why open escalation of the debt problem is not expected in the Chinese case.
Therefore, from the perspective of some Chinese elites, there may be (i) other more pressing issues for reform, such as high (and increasing) inequality and the need for an efficient pension system, and (ii) reasons to be cautious. Political and social stability are seen as more important than the efficiency of allocation of capital.\(^{16}\)

This means that there is still the opportunity to carry out reform before it becomes truly urgent, and this is most likely one of the motives for several recent pro-reform proposals and speeches made by representatives of the PBoC (Zhou Xiaochuan) and government (Wen Jiabao). But opportunity does not mean necessity. Ample evidence from other countries shows that reforms addressing long run issues tend to be postponed until the situation becomes critical, especially if the necessary steps are viewed as politically costly. The current extremely positive statistics associated with Chinese banks, in combination with the perceived failures of the financial systems of many other countries, may thus prove to be a mixed blessing.

\subsection*{2.6 Inherent Logic of Power and Control}

The logic of power and control has been, and will most likely remain, the single most influential factor in discussion over the future structure of reforms. While close relations between top business leaders, banks, and political elites are common in many countries, these relations reach a special level in China. Most importantly:

1. The state/CPC officially controls SOEs;

2. The state/CPC controls the top banking institutions and has the power to negatively affect SOEs and local administrations;

3. Many influential CPC members have relatives who enjoy high positions in SOEs and banks.

\(^{16}\) The observed mix of reform proposals, implementation of partial measures, and only slowly changing basic features of the system suggests that the opinion within the Party is far from homogenous on the topic of financial reform.
Contacts and influence are thus important for stabilising one’s position in both business and the Party structure. Although this tangle presently has a relatively stable form, any deeper changes could necessitate a more complicated strategic game. Liberalising financial markets and increasing the role of independent foreign entities in the market could thus be politically risky, as it could restrict the ability for individuals to use this channel to gain support from others in the network. The third feature means that when the opening of Chinese markets is discussed, the interests of the strong domestic incumbents are extremely well represented in debates over future policies.

While it is theoretically possible that the Party could use existing channels or open new ones in order to exercise at least some influence over foreign banks, which could reduce the Party’s fear of losing control over the financial sector, such strategies are still more risky than sustaining the status quo.

2.7 Capital Account, External Macroeconomic Equilibrium and the Internationalisation of the RMB

While the Chinese balance of payments may be very appealing to mercantilists, excessive accumulation of foreign exchange is a symptom of macroeconomic disequilibrium and creates problems for the central bank. The most appropriate response to this macroeconomic dilemma would be a combination of a change in the exchange rate regime (transition to floating, which is gradually being implemented) with increased convertibility of the RMB. The latter feature in particular is directly linked to the liberalisation of the financial sector and is also a prerequisite for an increased international role for the RMB.

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17 There are several such channels, e.g.: (i) Foreign investment banks operating directly in Chinese market are also required to participate in a joint-venture with a Chinese partner. Control over the partner is then obviously sufficient for achieving control over the whole joint-venture (esp. if the share of foreign bank is capped at 1/3 or 49% under the new rules promised in May 2012). (ii) Even non-state enterprises (including foreign owned or controlled) have party presence in their company – primary organizations of the party and in some case even full-time party secretary.
3. Liberalisation and Deregulation: Future Trends and Opportunities

Chinese policy-makers know that reform is needed (especially in the long run) and have taken (often costly) steps signaling their determination to liberalise the sector (for example, through recapitalisation of top banks – ABC received RMB 130 bn [almost EUR 13 bn] in 2008). However, adoption of further steps is selective and gradual. True liberalisation will only succeed if those in power are strong and act to maximise the long run welfare of the country regardless of the effects on their own position, or if elites find an alternative mechanism which allows them to do without control over finance. It is unclear whether any of these factors apply to the current PRC and even unclearer how the new administration will behave as it strives to stabilise its position in a potentially complicated macroeconomic environment.

A sudden real change in the way that Chinese financial markets operate is therefore unlikely and we should instead expect a sequence of gradual and partial (sometimes superficial) changes through which the CPC attempts to deal with problems without sacrificing too much, or are related to issues that coincide with the interests of the top players. It is therefore logical to expect that the Chinese capital market will still depend on banking in the future and that the fundamental features of Chinese banking (such as the importance of political factors and dominance of local banks) will change only very slowly. In short, the Chinese financial sector will change in an evolutionary and not a revolutionary way.

3.1 Implications for European Financial Institutions

The aforementioned factors (especially 2.6) mainly apply to banking because of its vital role in financing companies. Other parts of financial services that are less important for control over the economy are less likely to be viewed as sensitive and are therefore more likely to enjoy faster liberalisation. This can be verified by the relative success of foreign institutions in the insurance market and in consumer credit.

The assumed gradualism of deeper changes together with the tradition of ‘bird cage economics’ suggest that real restrictions on the activities of foreign banks are likely to be reduced slowly and perhaps unequally, for example, through regional economic experiments. Such opportunities should definitely be

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18 Or for containing the looming debt problem.
embraced by foreign companies – while they will not bring substantial market shares at the national level, they will help them improve their knowledge of the environment.

The restrictions mentioned in section 2.1 together with the fact that China has been able to finance existing high investment rates from domestic savings imply that useable strategies for the expansion of foreign banks remains limited.

However, there seem to be three main opportunities for expansion in the activities of European banks in China:

1. Financial innovations, i.e. innovative products, especially products focused on niche markets which have not caught the interest of current market players. One successful example of this approach involves consumer credit and the successful market entry of PPF Group N.V. with their Home Credit project. Future opportunities may include foreign currency accounts for Chinese citizens, though this requires further changes in regulation.

2. Focus on supplying services to foreign enterprises and nationals active in China. In the past, a similar mode of expansion has been used by, for example, Japanese banks during their expansion abroad. The obvious competitive edge of European banks lies in knowledge of their clients and in trust related to confidentiality of information.

3. Alliance (joint-venture) with a local partner (often inevitable because of regulatory requirements) in which the European partner can base its position on reputation (brand) and experience.

At the same time, European banks should be ready for future attempts of Chinese banks to expand abroad. While such ambitions have been to some extent suppressed by economic factors19 so far, related policy measures have been announced20 and Chinese banks are becoming increasingly active.21 Future expansion of such activities depends on similar factors as financial liberalisation – as long as the

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19 Firstly by the primary role of the banks in the domestic economic policy, secondly by the negative experience with losses related to similar attempts in 2007 - e.g. investment of CIC into Morgan Stanley.
20 For instance, the ambition to open subsidiaries or branches in Central and Eastern European (CEE) countries was outlined in a 12 point initiative towards CEE announced by P.M. Wen Jiabao in April 2012.
21 Bank of China already has 21 branches in the EU (7 of them in the UK).
banks are required to play the role of a cushion or support mechanism for provincial governments and key companies, the scope for their foreign expansion may be limited. Reforms of the Chinese financial market therefore not only open the market for European companies, but they can also indirectly open new opportunities for Chinese banks in the EU. We can expect that such activities would be primarily focused on (i) acquiring market skills, expertise and information,\(^{22}\) (ii) trade financing – here it would form part of wider effort to increase the share of Chinese companies in the value chain of exports of Chinese commodities to Europe.

4. Conclusion and Policy Implications

Although theoretical economists express their concerns about the long run effects of the state-managed banking sector on the efficiency of allocation of capital and the microeconomic efficiency of companies, it seems that other (political and power-related) factors are likely to prevail and that the current system will only see slow change. We can therefore expect that the dominant role of banking and the small role of foreign competition in the financial market of PRC will be preserved.

While nominal barriers to foreign activities may be reduced and foreign entities will be able to increase their participation in Chinese financial institutions, their real role in Chinese markets is unlikely to increase fast. As far as the EU and European business are concerned, European financial institutions are not without opportunity. Liberalisation will be faster in sectors that are less directly related to control over the economy (insurance, consumer credit). In banking, however, the nature of current regulation restricts the set of usable strategies. While the share of foreign banks in the Chinese market (and related profits) will become more diverse in future, it is unlikely that the Chinese market will become as dominated by foreign financial institutions as the markets of the transition economies. At the same time, EU should expect that attempts at either market entry or M&A activities by Chinese banks (and sovereign investment funds) as well.

The situation is different at the policy level. It seems that the financial crisis, together with the loss of face related to EMU woes and requests for Chinese assistance, has further reduced the chance for the

\(^{22}\) Especially the UK and Germany seems to be quite attractive from this point of view.
recommendations of EU officials to have any direct effects on Chinese financial policies. Indeed, the PRC is even more likely than before to prioritise bilateral contacts with top EU players (Germany, France, UK). The EU has three main options: (i) to fund research on the Chinese financial system (and especially its effects on the stability of the Chinese economy) and thus offer its expert assistance, (ii) stabilise the EMU and painstakingly rebuild its reputation, (iii) rely on standard WTO procedures.
Appendix

Chart I – Total Value of Stocks Traded in terms of GDP (%), 2001-2010

![Chart I](chart_i.png)

Source of data: WDI

Chart II – Stocks Traded, Total Value in current EUR (2010)

![Chart II](chart_ii.png)

Source of data: WDI and ECB (USD/EUR conversion rate)
### Table I – Global Top 20 (Ranked by Market Capitalization)

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Source: Financial Times, Global 500 (various years)

### Table II – Banks in Global Top 20 by Countries

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Source: Simple ranking based on Financial Times, Global 500 (various years)

Note: again based on ranking related to market capitalisation