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Economic Reform in China;
Its Impact on Hong Kong Economy and Japanese Bank Operations in Hong Kong

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Yutaka Masaoka

Abstract:

This paper examines key elements of economic reform in China, their impacts on Mainland China and Hong Kong (HK) economies after China’s entry to the World Trade Organization (WTO). The paper also introduces the current activities of Japanese banks in HK. It is mainly based on the exchange of views with local academics of research institutions, economists of foreign banks and staff of Japanese banks. The exchange of views was undertaken from the end of 2000 to mid 2001. Those views and observations expressed in this paper represent those of the author and do not reflect those of the organizations to which the author belongs.

The main issues discussed in this paper are the following:

1. The recent developments of China’s macro economy and the progress in the financial reform;
2. The impacts of the China’s entry into the WTO on the financial market in Mainland as well as in HK;
3. The future of HK as an international financial centre;
4. Japanese commercial banks’ operations in HK; and
5. The relationship between Japanese commercial banks and the HK supervisory body.

1. The Current Status and Prospects of China’s Macro-Economy

Since capital transactions have not been completely liberalised and the scale of

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Chinese economy is large enough to absorb external shocks, China, although its growth slightly slowed down, has not been significantly affected by the Asian financial crisis that took place in July 1997. After the crisis recovery began with an increase in export. Although, from the forth quarter of year 2000, export growth and public investment have slowed down, they are now regaining their usual strengths. The majority is optimistic about the outlook of China’s economy. The GDP growth rates in real terms of year 2000 and the first half of 2001 resulted in 8% and 7.9% respectively. It is likely that the current growth rate of 7-8% will remain as a base case, the export and capital inflow are also expected to remain promising and the level of prices continues to be stable. China will have to face various challenges during the 10th Five-Year Plan that was announced in February 2001. The challenges are those of managing reform and liberalisation, boosting productivity through restructuring of the industrial sector, adjusting regional imbalances through development of the inland west, and improving the environment, education and social welfare systems.

The main risks that China are facing now include a social risk of an increase in unemployment, a financial risk of how to deal with non-performing loans (NPLs), and an external risk such as the business slow down in the United States and a political risk of change in laws and regulations. Nevertheless, the majority views that the Chinese government should be capable of handling all these risks and they would not lead to serious problems.

Opinions are diversified as to domestic private consumption. The optimists predict that personal consumption will grow as the reform of state-owned enterprises (SOEs) and social welfare system will be soon concluded. A sign of recovery of consumption has already been seen. The pessimists, on the other hand, have some concern that a negative cycle may set in. Namely the reform of SOEs may lead to a fear of future unemployment, which, in turn, may lead to a concern over an eventual increase in the burden of the social welfare system, affecting consumer spending. This, in the end, may affect the performance of SOEs and, therefore, the pace of reform has to be accelerated. The ultimate result brought out by this cycle could be a stagnant consumption growth. In either case, the overall direction of consumer spending, which accounts for more than 60% of GDP, is a crucial factor influencing China’s gigantic economy and its sustained growth.
There had been speculations on possible depreciation of the Renminbi since the Asian financial crisis. But it has not been carried out. Apart from avoiding contagion on other Asian currencies and political factors a possible reason for not depreciating the Renminbi could be trade-offs between merits and demerits of such an action on the Chinese economy. The merit of depreciation would certainly be an increase in export volume. But there are many options of export promotion policies available to the Chinese authorities, including an increase in the add-on refund tax imposed on export-oriented enterprises. The currency depreciation would mean an inevitable increase in import cost of intermediate goods, which makes the depreciation policy far from profitable. As expressed by China experts this time, the export-oriented enterprises themselves did not have strong desire for depreciation. And they did not consider there was any absolute need to depreciate the currency considering the present state of trade balance, the continued inflow of foreign capitals and the strong foreign exchange reserves. Even in the currency black market, which tends to reflect the real market price, there were no signs of the premium that signal any demand for depreciation. The majority predicts that depreciation or similar policy will not be realistic at least in the foreseeable future after China’s entry into the WTO. In line with other economic reform policies, it is likely that the fluctuation range will be monitored using pilot scale tests and it will be gradually widened responding to reactions from the market.

2. The Direction and Prospects of Financial Reform

The economic reform in China is being carried out steadily in a comprehensive manner. In the financial sector, many important measures have come into effect since 1998. In parallel with reducing the reserve requirement on savings deposits, both capital injection into state-owned commercial banks (SOBs) and revision of the lending regulations to indicative guidelines have been implemented. Furthermore four asset management companies (AMCs) were established in an effort to isolate NPLs from SOBs and structural reform of PBOC was carried out. These actions were taken to in-plant a market mechanism in various parts of commercial bank operations, strengthening a managerial base of SOBs. It is still premature to provide any evaluation on the performance of AMCs only after the total amount of approximately RMB1.4 trillion was transferred from four major state-owned commercial banks to AMCs and those AMCs have started operations. It is reported
that by the end of June 2001, AMCs recovered approximately RMB370 billion worth of NPLs or nearly 10 percent of the transferred assets. It is also reported that AMCs have carried out debt-to-equity swap in 580 companies. Yet the majority’s view is that it may take over ten years for AMCs to clean up existing NPLs and at best the final recovery rate would be in the range of 20-25%. Speculations are varied as regards future directions of AMCs among officials of AMCs, SOEs, SOBs and local governments. The AMCs received a government notification in November 2000 on how to secure financial resources. It included an issue of bonds guaranteed by the Government, borrowings from PBOC, and domestic and foreign banks. On the other hand, many foreign financial institutions such as Deutsche Bank, Price Waterhouse and Coopers are trying to participate in China’s A share Market by joining the NPL management scheme. This is because of the fact that most of the NPL debtors are either listed companies in A share market or major owners of such companies.

Regarding the move of the capital market, several progresses were made in past two years. Notable ones are a sharp increase in stock investment by SOEs and insurance companies, liberalisation on financing stock investments and on the use of stocks as collateral by securities companies when they borrow money from commercial banks. Apart from these progresses there are other moves and rumours in the market. These include an announcement of an integration plan of the Shanghai and Shenzhen Stock Exchanges, an introduction of the national futures stock price index in the early 2001, and also possible merging of the B share to the A share, etc.

It is quite possible that the reform process may be slightly accelerated after the accession to the WTO but in moderation. Quite a number of China experts from Europe and the US stressed repeatedly that rapid reform and liberalisation after the accession to the WTO may affect the SOEs and SOBs. On the other hand, the views expressed by local academics in HK are quite different and they do not expect such serious impact. In fact, the Chinese government so far has launched a variety of reform measures on an experimental basis, and then expanding them steadily to other areas. In order to alleviate various possible impacts after the accession, the Chinese government should adopt a practical approach to adjust a speed of the reform in a flexible manner. In case of the banking sector, the
majority considers that local banks in China still possess great advantages in terms of their relationships with domestic customers, in areas such as communication and networking of branches in Mainland. Nevertheless, there are voices of concern on rapid and massive individual deposit shifts towards foreign banks that will offer much more sophisticated retailing services than the local banks. This should deserve special attention. The minimum common understanding would be that the competition with the foreign banks would be intensified after the accession. On one hand, this will be a big business chance for the foreign banks. On the other hand, this will be a pressing and teething issue for the local banks in the short-term but will definitely be a rewarding challenge for them in the long run.

3. Competition among Banks in Mainland

Inevitably, competition will become intensified among local and foreign banks in Mainland China after China’s accession to WTO. The local banks in HK such as HSBC, Hang Seng and the Bank of East Asia, are familiar with business practices in China. The majority has a view that these banks are enjoying comparative advantages over foreign banks because of their prevalent popularity and connections with China and the circulation of the Hong Kong dollar. Because of minimum requirements of an asset size for entering the Chinese market, small and medium sized banks in Hong Kong will eye on the market with the possibility of reorganizing themselves through mergers and acquisitions.

Foreign banks are seeking business opportunities in the retail banking field which is promising with the huge population base. One commercial bank in HK seems to have completed a detailed review of the market. Japanese banks are slow to develop their strategies. (Additional References 8)

4. The Impact of China’s WTO Entry on Hong Kong

Being a gateway to Mainland China and a starting point of doing business with China, HK will benefit from this strategic position in the short term. The trade and investment through HK, as an entrance to China, will expand. However, opinions are diversified among local academics as to the long-term outlook. The optimists, in support of “business confidence”, see that the Chinese government will continue to
treat HK as a special city and tap its resources. China will need a long time to improve its own physical and social infrastructure whereas it has to attract an increasing number of foreign capitals under the WTO regime. The pessimists, on the other hand, predict that China will soon catch up with HK and eventually an unemployment problem may develop in HK, since businesses including the service sector will shift from HK to Mainland due to extremely high labour and rental costs in HK.

It is certain that competition among cities in China will intensify. HK’s long-term survival depends on its sustained strengths in human resources and infrastructure that support an international city like HK. Other factor in play is at what pace the infrastructure can be improved and deregulations take place in other cities of China.

5. The Status of Hong Kong as International Financial Centre

There exists a uniform view that HK as an international financial centre is unlikely to be replaced by Shanghai or other cities. There are two questions relevant to the view; i.e. how long would it take for the Renminbi to be fully convertible and does it make sense to have two international financial centres in China? The Chinese authorities unofficially addressed the first question recently in that it may take 15 to 25 years before full convertibility. Furthermore scholars from the Chinese Academy of Social Science, who visited the Hong Kong Institute for Monetary Research in mid 2001, also concluded that the Renminbi’s full convertibility would be achieved only after removing the restriction on capital account transaction and currency exchange. 6/ Relating to the question of the permanent location of the international financial centre, the matter has to be addressed in the context of different functions between the international financial centre and financial centre for China. Japanese banks are now returning to HK and other Asian countries after the aftermath of the financial crisis, and now tend to be increasingly careful about liberalisation and globalisation development in the world financial market. Furthermore, Shanghai now operates as a financial centre for China and Hong Kong as Asia’s international financial centre. In addition HK is supported by China’s economic activities particularly in southern part of China and that places HK in a unique position, making HK a stronger and better financial centre for China. 7/ If
HK turns into a financial centre for China, that may inevitably weaken HK’s role as an international financial centre. However, given the size of China’s economy and its possible integration into the world economy after the accession to WTO, these two functions might become complementary rather than conflicting.

The majority of Japanese banks in HK also agree that there would not be any immediate change on the status of HK as the international financial centre (the time scale they have in mind varies from three to ten years.) It is also expected that social infrastructure set-up in Mainland will take time even after China’s entry to WTO. According to the Japanese banks, the biggest bottleneck of doing business in Mainland is unpredictable nature of various regulations and procedures. Currently, since China itself is implementing reforms with trial and error, laws and regulations are likely to change from time to time. There are many associated complaints. For example, it is pointed out that it takes almost a week to complete contract documentation in China whereas it can be done overnight in HK. There is no assurance of trouble-shooting even if money is not remitted successfully to a recipient. Furthermore, even if the Renminbi business is liberalised in 5 years’ time, the business may end up in a situation of monopoly by the SOBs. And to what extent will the inter-bank money market be developed when it is currently oligopolistic? Attitudes of the Chinese authorities toward the liberalisation of capital transactions appear to be conservative. Overall, Japanese banks view HK still enjoying privileges over other cities in China.

If we compare HK with Singapore, HK performs more or less the same function as Singapore in terms of borrowing and lending operations. But when it comes to securities-related business, HK enjoys overwhelmingly larger share than Singapore does. Those businesses include investments in listed stocks in Hong Kong, gathering information on investments in unlisted stocks and consulting business of European and US management firms. In this connection, there are opinions expressed about the advantageous position of HK. Irrespective of this, quite a few Japanese banks closed their branch offices in HK while maintaining their offices in Singapore. Additionally, some Japanese banks point out that although HK enjoys support by the real economy in Mainland, the HK dollar is pegged to the US dollar and, therefore, is prone to be affected by fluctuations of the US economy.
6. Presence of Japanese Banks in Hong Kong

The number of Japanese banks in HK decreased from 91 in 1997 to 35 in June 2000, a steep drop of 60%. The outstanding balance of loans in the HK banking sector in the corresponding period also decreased from HK$2 trillion (approximately 28 trillion Japanese yen) to HK$640 billion (approximately 9 trillion Japanese yen), which represents a decrease of 70%. The Japan’s share of loans significantly decreased from 51% to 25%.

A few leading commercial banks point out that this drastic drop of Japanese banks’ presence is often misunderstood and the real picture should be different. In fact, most of the decrease was due to transfer of Euro-Yen loan from HK market to Japan. Now that deregulation and floating interest rate loans were implemented in Japan, the Euro-Yen loan transactions through HK market have no longer necessary. Most of the Euro-Yen loans were booked with Japanese enterprises and their decrease does not necessarily reflect a change in the business of Japanese banks in HK. While the number of banks was reduced, most of them were local representative or liaison offices that did not have substantial businesses from the beginning. According to the Japanese banks, the monetary authority in HKMA has come to know the real picture.

Yet, medium and small size banks expressed that Japan’s presence has certainly decreased as a result of withdrawal of Daiwa, closure of Sumitomo Trust Branch and compression of core assets by many Japanese banks. It is natural that reactions are varied among Japanese banks depending on their scale of business and nature of activities.

Overall, the downward adjustment is almost over after the transfer of Euro-Yen assets to Japan and the compression of core assets by Japanese banks in HK. In addition, as a result of active participation in syndicated loans, Japanese banks are gradually returning to HK even though big projects like airport construction has been completed and HK’s overall demand for capital remains weak. There used to be major capital intensive projects in the Mainland China, but now Japanese banks face difficulties with ITIC problems. In addition, Japanese economy itself remains weak, and the non-performing loan problem is yet to be addressed completely. All
these factors explain why Japanese banks are still hesitant to be fully involved in China operations.

7. Activities of Japanese Banks in Hong Kong

Japanese banks are not pursuing retail business in Hong Kong. They are undertaking wholesale business by raising funds from the inter-bank money market and by carrying out lending to Japanese companies in HK or local large companies. In the process, local banks go to the “over deposit” position while Japanese banks suffer from the “over loan” position, in that the availability of the HK dollar to the Japanese banks becomes very low from time to time. This leads to an increased risk in doing business in HK. Japanese banks still remember the time when HIBOR hit 200% at one point in time during the Asian crisis.

The rationale behind not pursuing retail business on part of Japanese banks in HK is that there exist restrictions on the number of branch offices Japanese banks can operate from. This fact put Japanese banks in a disadvantageous position vis-a-vis local banks which do not have restrictions on the number of branches where they could handle retail business. Japanese banks consider that at least 20 to 30 offices are needed for retail business. Apart from the retail business, mortgage loan and credit card businesses will not be profitable since competition from local banks is fierce and also taking into consideration high operational costs in HK.

Japanese banks operating in HK can be categorized into three types according to their business lines: i.e. (i) those concentrating on Japanese companies in HK, (ii) those concentrating on both Japanese and local companies in HK and (iii) those mainly conducting intelligence gathering or providing various logistics for their customers in Japan. Typically, the Tokyo Mitsubishi Bank falls under the first category, inheriting the customer base of the pre-merger Bank of Tokyo with heavy concentration on Japanese companies operating in HK. Sumitomo-Mitsui Bank and UFJ Bank fall under the second category. They target for not only Japanese and local major companies but also local small to medium-sized companies. The distribution between the Japanese and local companies is approximately 50-50.
Regional banks of Japan are mainly taking care of customers of their regional coverage in Japan who come to HK, or they are engaged in intelligence gathering, in other words, in non-banking services. One may argue that the business of intelligence gathering may not be justified given high cost of running offices in HK. On the other hand, the withdrawal of Japanese regional banks from HK has almost come to an end.

What would, then, mergers and restructuring of Japanese banks bring about? Those three banks that are to become the Mizuho Group are individually undertaking similar businesses, and they may expand the scale of their business by more than three times after the merger. Fuji manages dealing business and corporate financing for large-scale Japanese and local companies while Industrial Bank of Japan concentrates on corporate financing for large-scale companies and DKB operates somewhere in-between.

8. Japanese Banks and Hong Kong Monetary Authority

Whether the financial market works well greatly depends on how the working relationship between financial institutions and a supervisory body is built up. Japanese banks and the Hong Kong Monetary Authority (HKMA), in general, enjoy a good and reliable relationship. The Japanese banks' impression are such that the most rules driven financial supervisory body is the Federal Reserve System of the U.S., followed by British FSA, Singapore MAS, and HKMA.

It is also pointed out that HKMA does intervene in many policy issues from time to time and there are voices raised by Japanese banks questioning if HK follows a "free and open market". Here are some recent incidents witnessing it. Firstly, although the amount of US dollar is not clear (that is the cost will definitely be going up if the retained cash has to be increased) when the US dollar RTGS is introduced (it started Dec. 2000), the HKMA made a very hasty decision and started implementation without any trial period. Secondly, there was a "pressure" from the HKMA to accept the reschedule plan for a local company (or at least Japanese banks felt it was a pressure). Thirdly, the approval for one Japanese bank, which plans to restructure and shift part of its functions from HK to Japan, has been pending for a long time. Fourthly, in connection with the idea of creating HK-based
rating agency, Japanese banks are requested to provide some internal information on how they access and rate the performance of their clients. Especially as for the second case, they did not imagine at all the similar case in Japan, and it seems that the considerable amount of frustration had persisted. In general, while Japanese banks to some extent appreciate HKMA’s quick decision and quick implementation by using the advantage of small government, they from time to time get frustrated with HKMA’s decision without “due and sufficient” consideration.

Certainly all these are from the Japanese banks’ viewpoint. HKMA itself insists that it had been fully consulting with Japanese banks on the reschedule issues or the introduction of US dollar RTGS. It also said that it has established a working group on the commercial credit reference agency and is now consulting with the Japanese banks on these proposals. Apart from the argument on right or wrong, what is most important is that at least HKMA assures high transparency in the process of policy decision-making. In fact, Japanese banks all agree that HKMA is quite open to various views and comments and some Japanese banks even pointed out that HKMA is conducting their business much better than Japan in the terms of transparency. Certainly to what extent views and comments solicited are reflected in their final decisions remains unclear. However, when we discuss about the “openness” of HK market, transparency would be more important than the issue of whether the supervisory body intervenes private business.

In general, all Japanese banks pay more attention to the relationship between HKMA and the Chinese Government after reunification of HK and China. After the China’s entry to WTO, China’s financial market is expected to become more open.

Against this background, we should keep an eye on how their relationship will develop, and also how this transparency in policy-making will change.

Summary

The following are the summary of observations:

1. Regardless of the slow down of the world economy, the majority is confident
about the future performance of Chinese economy from the medium to long-term on the ground that Chinese economy is led by domestic demand and not by factors external to China and the authorities are expected to take a gradual approach and take various moderating measures in pursuing its economic reform after the entry to WTO.

2. After China's accession to WTO, it is quite possible that the competition among Chinese local banks and foreign banks will intensify in Mainland China. Under such circumstances, what kind of role Japanese banks will play is a matter of concern but remains unclear.

3. Regarding the future of HK as an international financial centre, there is a consensus that at least in the short run HK will benefit from the China’s entry into WTO. Views are varied; some are very optimistic and others are very pessimistic about its impact on HK in the long-run.

4. In the HK financial market, what is the most important seems to be transparency in a policy making process. The question still remains how this transparency issue will be affected as a result of the reunification of HK to Mainland China.
Appendix I

Demand side (Short run)

Consumption \rightarrow Unemployment

Social security system

Income disparity \rightarrow Go west policy

Investment \rightarrow Fiscal constraint

Chinahs economy

Trade

Im Ex

FDI

Positive

Negative or uncertain

Supply side (Long run)

Structural change

Market-oriented

Competitiveness

Technology breakthrough

 accelerating

Chinahs entry to the WTO

Appendix II Summary of Major Meetings

Foreign Bank A

1. The Current Situation and Outlook of the Chinese Economy

The economy is performing satisfactorily in general having only small impact from the Asian crisis. Though the foreign investment and trade dropped slightly, it had reached the bottom. Steady growth of 7-8% will continue for next two years. With the opening up of the market, trade surplus and the capital influx will continue to increase. Both the risks of high inflation and deflation are not in place.

The impact of the Asian crisis was small due to the foreign exchange regulation. And also the scale of the Chinese economy is big enough to have room for adjustment and absorb external shock. A variety of crisis management policies, including export promotion measures also contributed to mitigating the impact.
2. The Economic Reform

The economic reform is steadily progressing. The banks are required to become more and more responsible for their loans and therefore, the enterprises are having hard time to borrow money from the banks. The SOE's reform has given rise to an increase in unemployment. The reform in the financial sector has caused the problems like GITIC. However, these problems are the inevitable side effect of the reform, and should be welcomed from the reform perspective. The ITIC problem will persist for a while.

Though it may take three to five years to clean up the bad debts, the influence may last for ten years or more. For example, it will take ten years for the AMC to handle the bad debts. AMC eventually may be transformed into the commercial banks, or some may be closed down.

AMC have to pursue the restructuring of SOE, facing huge resistance from the SOE, shortage of human resources, and also the immature capital market. Therefore, the reform is gradual and slow but it is in progress. After five to ten years SOE will completely change.

3. The Fiscal Reform

The fiscal deficit is indeed increasing but still controllable. There are two reasons for the hidden deficit, namely, the pension and the various policy loans. However, the pension system in China, which is a socialist country, is ironically smaller than the one available in the western societies. Some people point out that spending in this area will increase because of the SOE's reform, which in turn put pressure on the fiscal balance. However, if the Chinese government does not have money, then it just does not pay. Concerning the second point, if the project does not run smoothly, it will run into deficit. But if it succeeds, it will turn into a balance in the black. Similarly with the unemployment, some concern about the thousands of new unemployed each year, but we do not see any social unrest. We should not understand the authoritarian China by using the same criteria as the democratic western countries. It can be said that China is more flexible in some sense than western countries.
4. The Accession to WTO

China may take one to three years to adjust its economy after the entry to the WTO and therefore, major impacts may not take place so soon. But to what extent is China going to adopt various adjustment instruments in a flexible manner, is still unclear. Though various quantitative researches had been carried out, almost all of these are cheating ones.

Long-term effects have to be seen. The central government determines to observe the rules of the WTO though the local governments and companies tend to resist. Even without the WTO, China is going to carry out reforms. But the pace of reforms will be accelerated due to the accession. This is actually good news to China.

The accession to the WTO is also good news to the foreign banks since the RMB business will be liberalized in three to five years. But since there are many regulations left behind, progress has to be slow and steady. The foreign banks will probably work on the current situation and enlarge their business gradually.

Nevertheless, although the speed of the reform is slow, it is actually much faster than the one in Japan in the post-war era. In fact, China is trying to complete only in twenty years what Japan had achieved for almost forty years after the war. However, at the same time, it is not so fast as Russia's reform, which led to an extremely unstable economy. From this perspective, it can be said that China is the country, which is carrying out economic reform most successfully in the world.

5. The Influences on the Various Sectors

The coming five years during the 10th Five-Year Plan is a very important time. Restructuring of various industries, reforms of SOE and the expansion of private sectors will all be carried out. The IT sector is growing and the electrical appliances industry will become more export-oriented. Reform is also already in progress in the automobile industry.

IT, oil chemicals and engineering are the industries where foreign enterprises and
6. The Influences on HK

Basically, China’s entry to the WTO brings about many business opportunities to HK. The problem is whether HK will play that role. Shenzhen, Shanghai and Taipei all share this opportunity. The vital point is that HK is exposed to competition. Currently, everything is very slow in HK compared to China. The situation in the past is reversed completely to such an extent that some are saying, ‘China becomes HK and HK becomes China’.

7. Others

There is no doubt that the cooperation between China and ASEAN will be strengthened in the coming two to three years. In his visit to Singapore 2000, Prime Minister Zhu proposed the joint railway project. China’s relationship with Korea should also be strengthened. Though Taiwan’s investment will continue, it is unlikely to be long lasting after one round. In the meantime, the relationships with Russia, India and Japan are the most uncertainties.

Local Academics A

1. The Speculation on Depreciation of Renminbi during the Asian Financial Crisis

Though the speculation of the depreciation of Renminbi had been deep-rooted in the currency market during the Asian financial crisis, it was not executed. Renminbi is influenced by political decisions and not by economic concerns. Prime Minister Zhu said in the beginning of 1999 that, the depreciation of the Renminbi would lead to the depreciation of other Asian currencies, which did give a great im-
The importers were not hoping for the depreciation, exporters as well who benefit from the depreciation. Judging from the black market at that time, the hard currency premium vis-a-vis Renminbi was only slightly higher than 10%, which was not particularly higher than the usual premium.

2. The Trends of the Macro-Economy

Though the domestic demand, in particular consumption dropped during the crisis, the trade sector first of all began to recover followed by the economy as a whole. In spite of the appreciation of Renminbi compared with the other Asian currencies, the amount of FDI was not reduced. This reflects that the FDI is a long-term process and the political stability is the more important factor for making a decision on FDI than economic factors. As a result, the market share of FDI to China in the world is further enlarging.

In the future, the progress of the trade sector would deserve the most attention after the entry to the WTO. The World Bank predicts that China’s share of both import and export in the world will increase double. On the other hand, as the infrastructure of harbors in China was developing slowly, HK will enjoy the benefits of the re-exportation as an entrepôt. The HK government forecasts that, this would bring about roughly 1% of annual rise of its GDP for the coming five years. However, in the long term, prospect may not be so optimistic as the infrastructure of China is getting ready and the dependence on HK will be lowered.

In the meantime, China will achieve 8% growth, together with good performance in direct investment and capital inflow. Foreign reserves will also remain abundant. Judging from the recent black market movement, Renminbi should not be depreciated, as the premium is not particularly increasing.

3. The Economic Reform

The biggest problem is that the deepening of unemployment may cause a political or economic instability. However, this is an inevitable process for the transition period.
Not only the trade sector but also the financial sector benefits from the entry to the WTO. The competition will be intensified, which will provide more opportunities to the foreign banks. Though this may be a challenge to China’s local banks, the loans with political consideration are likely to be more commercially oriented and it will be good to China. HK local banks do advantages over the other foreign banks since they are already well known in China and so is the HK currency. Some of the China’s local banks may go into bankrupt but after the reshuffling, a few mega banks eventually may emerge.

It is difficult to assess the performance of AMC since it has just been established. The basic idea is not bad. The problem is whether investors can be found in the process of cleaning up NPL. Education and training for staff are also indispensable. Specialists are increasing but still not enough.

Local Academics B

1. The Macro Economy

The biggest problem now is that the domestic consumption is still sluggish. The consumption grew by 9% in 2000, which is below what the Chinese government expected. Though the GDP will grow by 8% in 2000 and 2001, these will mainly come from capital investment.

The Chinese government said that it would try to stimulate the consumption for the coming several years. But it faces two problems. The first is the increase in unemployment caused by the SOE reform. The second is also brought by the SOE’s reform: as the government is putting forward the reform of the social security system, people begin to concern that the future burden may be increased.

The external sector is improving a lot, achieving 13% growth of export. However, imports are increasing more. Consequently, the contribution of the external sector to the GDP is currently negative. It is unlikely that export can maintain the 13% growth in the coming few years (13% growth was achieved reflecting the recovery of other Asian countries after the Asian crisis. This factor has to disappear in the coming years.) On the other hand, imports are going to increase because of the en-
try to the WTO. Furthermore, capital investment cannot be increased so significantly due to the fiscal constraint. Judging from all these reasons we should not be optimistic about the Chinese economy.

2. The Impact of the Entry to WTO

The long-term impact depends on to what extent the Chinese market will become competitive in the coming several years. If the government succeeds, China’s economy as a whole will enjoy the benefits. However, such case will not be envisaged especially when the technological level of high-tech industries is very low and they will give in if the tariff will cut down before they catch up with the developed countries.

3. The Financial Sector Reform and WTO

Great impacts are expected. So far, some foreign banks are admitted to engage in Renminbi business in restricted areas such as Shanghai. Therefore, although people do not trust the local banks, they do not have any options but deposit their money to the local banks. Consequently, local banks are also not worried about the lack of liquidity. When foreign banks start Renminbi business after the entry, a tremendous amount of individual’s deposit may shift to these foreign banks.

Needless to say, local banks still do have many advantages like a wide range of branch network, transportation and communication. Yet these advantages are going to disappear sooner or later.

Initially there is a minimum asset requirement to enter the China market. Major banks in HK such as HSBC, Hang Seng and the Bank of East Asia are surely going to benefit and other middle to small banks in HK are likely to merge or reorganize to enter the market.

4. Asset Management Companies (AMC)

It is in a right direction, but the biggest problem is how to finance the necessary funds. Bond issue may be possible but it has to compete with other bonds since the
capital market is still immature. Also, the transferred amount is too small compared to the total amount of the bad debts. Already quite a number of specialists, who are as smart as those in HK or Japan, are working in Shanghai and other places. It is likely that more and more specialists will appear in the coming five years.

5. The Impact on HK Economy

It is likely that HK will benefit from the increase in trade with China, as China's dependence on HK's infrastructure is unlikely to change in the short term after the entry to the WTO. However, the investment environment in China will improve rapidly and various service sectors will shift from HK to the Mainland after the entry. This may worsen the unemployment in the service industry in HK.

The Chinese government will also do away with various favourable treatments for foreign companies including companies in HK step by step (for example, the tax payment on the profit is 33% on the domestic corporations while it is only 15% on the foreign corporations), in order to protect domestic corporations. As a consequence, HK corporations will be on the level playing field with the Chinese local corporations.

Moreover, the advantages of HK's investors knowing the business practice of China compared to foreign investors may disappear as the 'transparency' is expected to improve after the entry. Looking from all these, situations are not so good to HK.

Foreign Bank B

1. Macro-Economy

The view that the current Chinese economy is totally led by external demand is not necessarily correct. Rather, the overall domestic demand such as consumption and investment is in good condition. Since 60% of the GDP is composed by consumption, this means that the economic growth in China has become more sustainable. Investment will also continue to expand due to the stimulating financial policies for coming two to three years.
The Chinese economy has moved from excess demand to excess supply situation since the latter half of the 1990s, and how to stimulate consumption becomes a major topic. However, a vicious cycle has been developing for these two years. Namely, the reforms of SOE and the subsequent increase in unemployment and insecurity on the social welfare system led to the sluggish consumption, which in turn led to the downturn of the performance of SOE, accelerating the reform, which again led to a further sluggish consumption. Therefore, a balanced macro-demand policy and structural reform was required. Nevertheless, consumption is now recovering. The demand for high quality products and new products is strong and the potential demand for various services is also great (The share of the 3rd industry in GDP is still below 30%). Currently, the consumption is able to rise at a rate of 7% or above.

2. The Impact of Entry to WTO

In the short run, the export of the labour intensive light industries, such as textile will gain. And the capital inflow will also increase because of the FDI (Signs of the increase in contracts are already noticed). In addition, the reduction in tariff and the increase in people's confidence on reform and liberalization bring about the increase in consumption. Consequently 8% growth will be easily achieved. However, what is more important is the impacts on the institutional process such as by privatization caused by the SOE reform, and the effect on the sophisticated technologies in the finance and communication sectors (e-commerce banking etc).

The short-term impacts include a rise in unemployment, especially communications, agriculture, insurance, petrochemicals and retailing businesses. Therefore, it is unrealistic to expect early gains and a rapid reform. At the same time, the Chinese economy will not suffer from bad effects to such an extent that it becomes out of control. The reason is that, the Chinese government has various instruments, which control the speed of the entry of the foreign corporations without violating any commitment to the WTO (for example, the various cost of buying an automobile, banks can only set up one branch per one city etc.). Although SOE and local government may resist to pursuing reform and liberalization, the central government is determined to execute the WTO's commitment.
3. The Impact on the Banking Sector

The presence of foreign banks in China is still small, within the range of 2% approximately, judging from the total asset and loan outstanding balance. The biggest change resulting from the entry to the WTO is that business may be changed to focus on retailing business targeting at individual customers. Considering the population of China and also the fact that a variety of new businesses like credit card business have just start developing, this change is all the more important.

Moreover, the corporate financing and the M & A business will also expand. It is not surprising the foreign banks' loans grow by 40%, assuming that the total loans from 2002 to 2010 increase by 13% annually. In this case, the share of the foreign banks will rise from the current 2% to 8%.

Once market is open to the foreign banks, it is possible that many good customers will shift to the foreign banks. This will mostly affect the four major SOB, which now have these good customers. The commercial banks, which operate under the shareholder system, and the local banks, will not be affected, as they do not have these customers. However, it is not expected that the domestic banks as a whole will be affected seriously and go bankrupt. Firstly, there is a large room for maneuver where the Chinese government can adjust the speed of liberalization without violating the commitment to the WTO. Secondly, the domestic banks have the advantageous relationship with the government and local corporations. Furthermore, they have a wide branch network in comparison to the foreign banks.

Local Academics C

1. The Current Status and the Outlook of Macro-Economy

The growth rate without being much influenced by the Asian crisis, stayed at only 1–2% below. The growth rate recovered to 8% in 2000. The deflationary pressure also comes to an end, rising with a slow pace of 1%.

With a smooth capital inflow in the coming two to three years, we should basically be optimistic about the economic outlook. Since China is an oil importing country
on net basis, there may be some effects caused by the oil price increase. However, the oil price increase has already hit the peak.

Unlikely the economic stability, there remains some apprehension about the political stability. For instance, a number of violent incidences in the rural areas, which have not been reported, have occurred. These uprisings are dangerous. Unemployment and lay offs also cause insecurity in the urban areas. Since China is a 'relatively' authoritarian country, people can quite openly protest to the government. Although it is possible to contain the rural uprisings, it is doubtful how long can such a system be maintained.

2. The Impact of the Entry to WTO

There was speculation about the depreciation of Renminbi during the Asian financial crisis. However, it was meaningless to depreciate 10% when other currencies were dropping by 40%. Though the flexibility of foreign exchange rate will be called for after the entry to the WTO, the Chinese government is extremely careful about this issue. The Bank of China is the only seller of foreign currencies in China's foreign exchange market and the PBOC is the only buyer. Under this system of 'bilateral monopoly', all the foreign currencies are concentrated in the PBOC (the forced settlement system. Certainly, the Chinese government does not officially call it a forced one) and the government decides the level of foreign exchange rate whatever they wish. We should see how such a system would change after the entry.

The impact on each individual sector is clear but it is difficult to judge the entire picture. The majority predicts that the annual growth rate will become 1 to 2% higher for the coming five years. Undoubtedly, the competition will become intensified and the efficiency will be enhanced. Some SOE may go bankrupt, but we need not worry about it. The entry to the WTO is just a beginning, and the Chinese government can alleviate the drastic change through the negotiations with other countries. The Chinese government is no idiot on this issue.

Looking at the banking sector, it is also doubtful that the foreign banks will benefit soon. For example, how the foreign banks assess the lending risks of the local com-
panies? The four major SOB still enjoy advantageous position. Industrial policies are also in place to watch over each individual sector. Only the Bank of China, which is specialized in the foreign exchange, will be greatly affected. The Bank of China itself is aware of this and already working on it. The recent announcement of the integration of the affiliated banks in HK is one of the examples.

3. The Economic Reform

The tax system experienced a crisis in 1992 to 1993 and was reformed after the advices from the World Bank in 1994. The SOE's borrowing from the commercial banks is actually a fiscal deficit. Therefore, as pointed out by the World Bank, it is necessary to look into real or hidden deficit. However, from the different viewpoint, it is possible to say that banks act as a buffer. The government also can take an initiative about the tax reform. In this sense, the fiscal reform is much easier to handle than the financial reform. In fact, the fiscal deficit was not increased to such an extent for these one to two years.

There is a vicious cycle in the financial reform and SOE reform. Namely, due to the change in the management system of the banks, loans become more commercial oriented, making the SOE borrowing from the banks difficult and thus causing a downturn in the performance of the SOE. However, the general situation will improve in the years to come. Historically, so-called J curve is often recognized during the reform process. Yet, it is not clear how long does it take to turn around though the government said that it would take only three years to sweep all NPL.

Although some of the foreign governments and specialists on the western side are still saying that the Chinese economy and local banks will collapse after its entry to the WTO, it should not be the case. In fact, the foreign reserves and the fiscal deficit situations have been much improved since early 1980s. China is definitely able to overcome the difficulties accompanied with the reform.

4. Privatization

Generally, there are two ways to carry out privatization. The first one is to privatize existing SOEs. The second one is to keep the existing SOEs intact and let pri-
Private corporations being developed in a new area (It is called parallel privatization and also called the Taiwan model). The ratio of SOEs and private corporations used to be 80:20 in Taiwan; now it changes to 15 to 75. Yet, almost all of the SOEs continue to exist. The second method is more gradual and smoother than the first one. The Chinese government studies the experience of Taiwan and tries to pursue the second method.

In fact, the Chinese government is very sensitive on this issue. Though 'opening up', 'reform' and 'competitive force' frequently appear in official documents, the word 'privatization' is seldom used.

5. Hong Kong Economy

Due to the aftermath of the sudden and short-term bubble just before the Asian crisis, the deflationary pressure still remains. Compared with Shenzhen, the office rent in HK is five times higher and the wages are ten times higher. Recently, many HK residents go to Shenzhen for shopping during weekends. The political barriers between HK and the North Shenzhen and Pearl River delta have disappeared now. We should see what changes would take place in HK once these areas are truly integrated and operated under the same market mechanism.

In the past, it was often said that HK was trying to catch up with the industrial performances of Taiwan and Korea. Now it has become completely impossible. Currently, it is said that HK is threatened by 3S, namely Shenzhen, Shanghai and Sydney. There are also people who add Singapore as the fourth S.

HK will benefit in the short run after China's entry to WTO. The foreign enterprises, which are not familiar with China, will still come to HK first. Yet, they will shift their offices to the Mainland as they become more familiar with China.

HK will continue to perform as an international financial center. As long as the Renminbi is not convertible, Shanghai and Shenzhen will not be able to become international financial center. Even if Shanghai becomes the international financial center, HK may survive as the 2nd international financial center. Nevertheless, the future of HK's is still dark. The population growth in HK is primarily attributable
to the influx from the Mainland and the population growth of HK itself is less than 1%, which is the lowest in the world. HK is a dual economy, which has two tiers. One tier is high value-added but creates less job opportunities. The other tier is low value added but creates plenty of job opportunities. The first tier is characterized by financial service sector, and the second tier by labor intensive sectors. So far the second tier has absorbed a lot of the Mainland immigrants. However, the sluggish consumption hits the second tier directly and the immigrants are adversely affected. This is one of the backgrounds of the HK government’s recent efforts on attracting tourism. Yet, it is doubtful to what extent tourism comes back when the price is high and environment pollution is not under control.

Local Academics D

1. The Impact of China’s WTO Accession on HK Economy

Majority’s view is that the China’s entry to the WTO is definitely positive to HK in the Long run. Although some transactions may go directly to the Mainland, HK, as an entry port for the Mainland, will play more important role than before, since China will call for more foreign capital and its trade with the rest of the world will more and more expand. As for the banking sector, even four largest SOB do not have enough international competitiveness, and it is doubtful that they will be able to fully compete with the foreign banks in five years time. However, labour-intensive sectors are comparatively efficient and also the government is expected to introduce some measures to protect the SOB. Therefore, it is wrong to expect that the Chinese economy as a whole will collapse.

In addition, the reform of retirement system will force people to save more money, whereas the capital market in China is still underdeveloped. Therefore HK will definitely provide a variety of financial instruments to invest.

Local banks in HK do have a great advantage to other foreign banks in penetrating into the China’s financial market. The initial action is very important for success, if you look at the CITI’s case in HK for instance. The reason why CITI, such a world leading commercial bank, do not capture satisfactory market share in HK, is that it took a mistake at the beginning. One problem for HK-based local banks is that
there will be a minimum asset requirement imposed on foreign banks to enter the market. Many small and medium-sized banks in HK will consider going to the China market through mergers and acquisitions.

2. **HK as an International Financial Centre**

HK will become an international financial centre in China thanks to its abundant human resources, and Shanghai will become a ‘financial centre for China’. Chinese government itself does realize that such regime is necessary in order to attract more foreign investment.

Shanghai certainly has been developing very rapidly. However, it will take at least 15 years for the Renminbi be provided full convertibility (one senior Chinese official said recently he expects 15–25 years). Furthermore, it does not make sense to have two international centres in one country.

After the accession, China will need more sophisticated financial services than before. In this connection, it should be noted that international society regards HK a truly reliable market. For example, legal system regulating security market in HK is much more reliable than Singapore. In Singapore, the court tends to make judgement in favour of Singapore authorities or the local companies and therefore foreign companies think that the judgement be unfair from time to time. Unfortunately HK also has suffered a few security scandals for past several years, but still international reputation remains much better than Singapore.

3. **The Strategic Relationship between HK and Mainland**

In order for HK to continue to be an international financial centre, HK should be different from other cities in the Mainland. If HK will end up with one of the local cities in China, it is a bad news to China. However, so far there has been no in-depth discussion in the Mainland on the role of HK after the China’s entry to the WTO. Recently the delegation from Chinese Academy of Science visited HK, but there were only few experts on HK economy in the delegation, and also their analysis seemed to be just following up the newspaper.
4. High Cost and Competitiveness of HK

This issue is often exaggerated. Many companies stay in HK in spite of its high cost, simply because they can make money in HK. In addition, high wage cost also means that there are plenty of well-trained labour forces in HK. All are the matter of market principles. One point is that, since HK offers such a high wage, HK government should make more effort to attract well-trained peoples from other countries including Mainland China and perhaps India. HK government is too slow in this regard.

Local Academics E

1. Macro Economy in China

Although export is falling due to the slow down in the US economy, consumption and investment are both strong. China’s economy has already got rid of depression. FDI on a contract base, which is a leading indicator, has been going up reflecting the anticipation of the entry to the WTO. The government official forecast of 7.5% economic growth must be conservative.

2. Reform of SOEs

In connection with the SOEs’ reform, it is announced that 3-year program for 98 to 00 has been achieved. In fact the earning ratio is improved significantly. However, taking account of the inaccurate accounting as well as the effect of the debt-equity swap, we should not accept the announcement as it is.

It is more difficult to improve the corporate governance rather than to improve the profitability. It might be easier to expand the private sector, keeping the SOE intact.

3. Impact of China’s Accession to WTO

Foreign investors are sceptical about this. H shares index, which used to be almost 1800 just before the Asian crisis, still remains 300 to 400 (as of early 2001). On the
other hand, the stock prices of red chips, which are the companies incorporated in HK, are going up, reflecting the anticipation of the accession. This means that foreign investors see that the China's entry to the WTO is a good news to HK but not necessarily so to China itself.

4. Financial Reform

There are too many concerning parties and conflicts of interest in this issue. Namely, AMC want to accept the debt of the companies with good future perspective, whereas banks try to transfer their worse or worst debts to the AMC. Moreover local governments try to get a ‘pie’ and even the SOE with good performance want to join this scheme. All these mean that it will take a long time to get on a right track.

It took about ten years for the United States to solve the S&L problem, which should have been much easier since most of the NPL are mortgage loans. In case of China, it will take more than ten years and it is quite possible that at the end of the day, Ministry of Finance will lose money.

Although SOB does have some advantage in terms of the branch network and communication, they definitely feel a great pressure about the China's entry to the WTO. In particular, small financial institutions like urban cooperatives will have a serious impact. However it is not expected that the whole financial system will collapse.

5. Fiscal Deficit

The Chinese government is expected to continue its expansionary fiscal policy, issuing government bonds. Ironically, tax revenue has been increasing for recent years. The main reason is, firstly attacking the smuggling which contributes to the increase in tariff revenue, secondly introducing the taxation on the deposit interest rates November 1999 in order to stimulate the domestic consumption. As for the latter, the taxation may not contribute to the increase in consumption, since many people only tend to shift their assets from deposit to other types of assets including some illegal transactions in order to avoid tax payment.
6. The Impact on HK

It is definitely positive in the short run. In the long run, its role as an intermediary point may be decreased slightly, but will not completely disappear taking account of the size of the Chinese economy, too many local governments, persistent protectionism in the provincial areas. HK's status as an international financial centre will remain the same at least for next ten to twenty years.

Notes

1/ In the past three years, the People's Bank of China (PBOC) intervened the Renminbi currency market a number of times, managing the rate of the Renminbi to US dollar from 8.2770 to 8.2800. The number of interventions has been reduced since April 2000, and the rate had been moved out of the range more than 20 times. According to South China Morning Post and other sources, a researcher of the research institute of the PBOC recently prepared a report that deserves some attention. From his perspective, the Renminbi should be allowed to float in a broad range between 10% and 15%.

2/ The Shanghai stock exchange is to be the primary stock exchange while the one in Shenzhen to be the secondary stock exchange. The Shenzhen is to be designed as Nasdaq in the United States. As the revenue of exchange fees would decrease in Shenzhen's exchange and resistances are building up, it is reported that the Chinese government is considering some alleviating measures for Shenzhen. The scale of the two exchanges combined is the second biggest in Asia, after Hong Kong's. This plan was launched late 2000. Since then A-share listing in Shenzhen market has been suspended in preparation for the integration of two exchanges and this also heightens the frustration of Shenzhen stock exchange. Almost one year has pasted after the announcement and yet no exact timetable has been released so far.

3/ Futures transactions of the national securities were prohibited to prevent the speculative transactions in 1995. Since then, future transactions have been limited to only three, namely on agricultural and commodity products. Previously there were 14 types of future transactions.
A shares facilitate transactions carried out in Renminbi and focus on domestic investors in China, while B shares focus on foreign investors, facilitating transactions carried out in US dollars (Shanghai) and HK dollars (Shenzhen). However, in reality, it was reported that domestic investors use various loophole methods to carry out a large amount of B shares transactions. The price level of B shares had been approximately from one-fifth to one-seventh to the level of A shares, reflecting each supply and demand conditions. According to one of the academics, the authority's 'acquiescence' to the Chinese investors' illegal transactions in the B shares market had been in fact a necessary evil to supporting the price level of B shares. Against this background, February 2001 China Securities Regulatory Committee (CSRC) announced to open B shares to Chinese domestic investors to some extent and in June took further deregulation on this matter. However, still many watchers on China seem to have a view that provided the Renminbi transaction and exchange on capital account continues to be inconvertible, it is not realistic to think about the integration of two shares within 3 years' time.

For example, regarding the liberalisation of interest rates, it is reported that the official from the PBOC expressed the view that to rush liberalisation is unfair to small and medium-sized banks under the oligopoly situation by large SOB. Therefore, they said that liberalisation should be gradual with the set up of the upper limit of the deposit interest rates and the lower limit of the lending rates (The interest rates of foreign currencies loan and large-scale deposit were already liberalised on Sep. 2000). Another example is the way of pursuing privatisation. Generally, there are two ways to carry out privatisation. The first one is to privatise the existing SOE. The second one is to keep the existing SOE and intact and to develop private companies in new area (parallel privatisation or Taiwan model). The second approach is definitely more gradual and smoother than the first approach. According to one local academic, Chinese authority studies deeply the experience of Taiwan and tries to pursue the second approach.

According to Shucheng Liu and Zhijun Zhao from Economic Research Institute of Chinese Academy of Social Science, there are three stages in the sequence of Renminbi's full convertibility. Those are firstly current account liberalization, secondly capital account liberalisation, and finally Renminbi's full convertibility. The first stage was over in 1996 when China became the member of IMF.
Article 8 countries and now China is experiencing the second stage. They pointed out that many people misleadingly expect that China's entry to the WTO will accelerate the second stage and thereby Renminbi will soon become a fully convertible currency. However, in their view, second stage should include not only removing the restrictions on capital account transactions but also include removing on restrictions on capital account exchange. The Renminbi’s full convertibility means removing in all aspects exchange controls relating to the Renminbi and it will not take place immediately after the entry into the WTO.

7/ According to information sources, the amount of the financing by all enterprises listed in the HK stock exchange in 2000 was a record-high of approximately HK$460 billion. Three quarters of this total was actually from the H share, or the Red Chips enterprises. These are, mainly, China Unicom (HK$440 hundred million), China Petroleum and Chemical Corp (HK$267 hundred million) and PetroChina (HK$223 hundred million) etc. It is estimated that there would be approximately US$125 hundred million new public offerings mainly from the communication sector in 2001. In the field of banking sector, plan of integrating the 12 HK-based affiliating companies by the Bank of China was announced at the end of 2000. It is reported that all the necessary procedures have been completed in October 2001. There is a rumour that the group will simultaneously go on listing their stock in HK and New York before long, financing a total of HK $5 billion.

8/ Recently, Citibank has transferred their main businesses from Singapore to HK. There are three main reasons listed up for this shift. First, Hong Kong is supported by China, which is to become a member of the WTO; second, its location is nearer to New York and Tokyo; third, HK is more popular among European and American expatriates in terms of climate and various social and economic environment. It seems that Japanese may think differently at least on the third point.

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