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**COMMUNICATION FROM THE PEOPLE'S REPUBLIC OF CHINA**

Assessment of Trade in Services[1]

The following document has been received from the delegation of the People's Republic of China with the request that it be circulated to Members of the Council for Trade in Services.

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China's Services Trade: Development and Experiences of the Opening-Up

This document was prepared pursuant to Article XIX:3 regarding assessment of trade in services. China believes that assessment is helpful for individual members, especially the developing members to participate in the current round of negotiations more effectively. Therefore, the aim of presenting this document is to contribute to the discussions on assessing trade in services under the special session of Council of Trade in Services and for the reference of other WTO members only.

This report does not prejudge any positions of the People's Republic of China on the negotiations on trade in services.

**INTRODUCTION**

1. The Uruguay Round negotiations resulted in the creation of multilateral rules on services trade for the first time, and made the first step in the long process of services trade liberalization. While the Uruguay Round succeeded in establishing the framework of General Agreement on Trade in Services, the efforts of members' liberalization were moderate.

2. China participated fully in the Uruguay Round negotiations as an observer of the GATT. On July 19, 1991, the Chinese delegation formally presented its initial offer of commitments on trade in services (MTN.GNS/W/124) and conducted negotiations with GATT Contracting Parties on the basis of offer and request. Later on, the offer was revised three times. In April 1994, China submitted its conditional offer of commitments on trade in services in the form of schedule of specific commitments (GATS/SC/19) according to the GATS.

3. Regrettably, China failed to resume its GATT Contracting Party status before 1 January 1995 when the WTO entered into force, and the negotiation on services became part of accession negotiations. In the seven-year negotiations from 1995 to 2001, substantial commitments were made. In some cases the level of opening-up was even higher than that of other members with higher level of economic development.

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[1] This assessment report was drafted based mainly on the material and statistics provided by the relevant authorities governing various service industries in China.

4. On December 11, 2001 China became a WTO member. Since then, the Chinese government has made utmost efforts to implement its commitments and foreign services suppliers have been granted meaningful market access in various services sectors.

5. This paper attempts to make a preliminary assessment of the development of China's domestic services industry and trade in services. Part I describes the development of China's services industry from 1978 to 2001. As a large developing country, China has accomplished tremendous achievements in economic development in the last decade, but its services industry started off late and is still at an underdeveloped stage. Taking into account the development level of China's services industry, it was not easy for China to make comprehensive and extensive commitments during the accession, therefore the Chinese government faces a challenge of how to coordinate the opening-up process with the development of domestic services industry. Part II analyzes the FDI into service industry in recent years. The research indicates that foreign capital inflows to services industry are speeding up and the market share of foreign investments increases dramatically. Since the service export lags far behind the trade in goods, China starts to focus on the issue of trade balance in services. Part III summarizes the experiences that China has had so far for the liberalization of its services industry. Part IV concentrates on the opening-up of the banking services, from which some preliminary conclusions are drawn.

## I. DEVELOPMENT OF SERVICES INDUSTRY IN CHINA'S ECONOMY

### 1. The Role of the Services Industry

6. From 1990 to 2001, China's GDP grew at an average rate of 9.3%, while the tertiary industry grew at an annual rate of 8.3%, which was lower. The proportion to GDP among three industries in 1989 was 25: 43: 32, whereas the proportion in 2001 was 15 : 51 : 34. Compared with 1989, the proportion of the tertiary industry in national economy increased by 1.6% in 2001 (See Table 1). In a dynamic perspective, the proportion of the tertiary industry in national economy continued to increase from 1978 when the economic reform was initiated to 1992, and has experienced little changes in recent years.

***Table 1: Changes of Proportions of Three Industries in China's Economy***

| Year | First Industry | Second Industry | Tertiary Industry |
|---|---|---|---|
| 1978 | 28.1 | 48.2 | 23.7 |
| 1989 | 25.0 | 43.0 | 32.0 |
| 2001 | 15.2 | 51.1 | 33.6 |

Data source: the State Bureau of Statistics, 2002

7. In terms of employment in the three industries, the structural change appears even more manifest. The employment in the tertiary industry increased from 12.2% of the total in 1978 to 18.3% in 1989 and 27.7% in 2001 with an annual growth rate of 0.7% (See Table 2). In a dynamic perspective, the distribution of employment in three industries shows the following trend, i.e., employment in the first industry declined, while that of the tertiary industry increased, and that of the second industry changed slightly. It was from 1994 that the employment of the tertiary industry surpassed that of the second industry.

***Table 2: Changes of Three Industries' Employment (percentage)***

| Year | First Industry | Second Industry | Tertiary Industry |
|---|---|---|---|
| 1978 | 70.5 | 17.3 | 12.2 |
| 1989 | 60.0 | 21.6 | 18.3 |
| 2001 | 50.0 | 22.3 | 27.7 |

Data source: the State Bureau of Statistics, 2002

8. The structural change of the three industries in the national economy is basically consistent with the pattern of the evolution of industrial structure world wide, i.e., the decrease of the first industry in national economy with the increase of other two industries. In terms of changes in proportion of the three industries, the structural change was most significant in the middle of 1980s', i.e., the proportion of the tertiary industry exceeded that of the first industry in 1985, and the growth of national economy was hence mainly driven up by the second and the tertiary industry instead of by the first and second industry. From 1990-2001, in the 9.3% annual growth of GDP, 5.8% could be attributed to the second industry, 2.5% to the tertiary industry, and the first industry, the remaining 1%.

9. In recent years, the tertiary industry played a more and more important role in creating jobs and absorbing unemployment of surplus labours, particularly in the urban areas. However, the efficiency of the tertiary industry remained low and needs to be promoted urgently.

## 2. Problems and Difficulties

10. Compared with most of other countries in the world, the proportion of China's tertiary industry in the national economy is much lower. Consequently, employment in service industry is also comparatively lower. Nowadays, in most developed countries the proportion of tertiary industry in the national economy has reached 60%-80%, and the average level of developing countries is around 50%, but in China, the indicator in 2001 was just 33.6%. With regard to the structure of the tertiary industry, the mainstream industries in the developed countries are information technology, consultation, research and development, and financial industries, whereas in China, the mainstream industries are commercial and traditional services (e.g. retailing and restaurants), and some infrastructural service industries such as postal and communication industries. Moreover, the gaps of development in services industry among various regions of China continue to expand (See Table 3). The Chinese government now is facing a huge task to develop the tertiary industry by all means and encourage investment from both home and abroad.

***Table 3: The Proportion of the Tertiary Industry in the Western, Middle and Eastern China***

| Year | proportion of the tertiary industry (%) | | |
|---|---|---|---|
| | Western | Middle | Eastern |
| 1978 | 18.8 | 18.1 | 19.5 |
| 1989 | 27.5 | 28.9 | 30.4 |
| 2001 | 38.3 | 35.4 | 40.2 |

Data source: the State Bureau of Statistics, 2002

## II. DEVELOPMENT OF TRADE IN SERVICES

### 1. Present Situation of Trade in Services in China

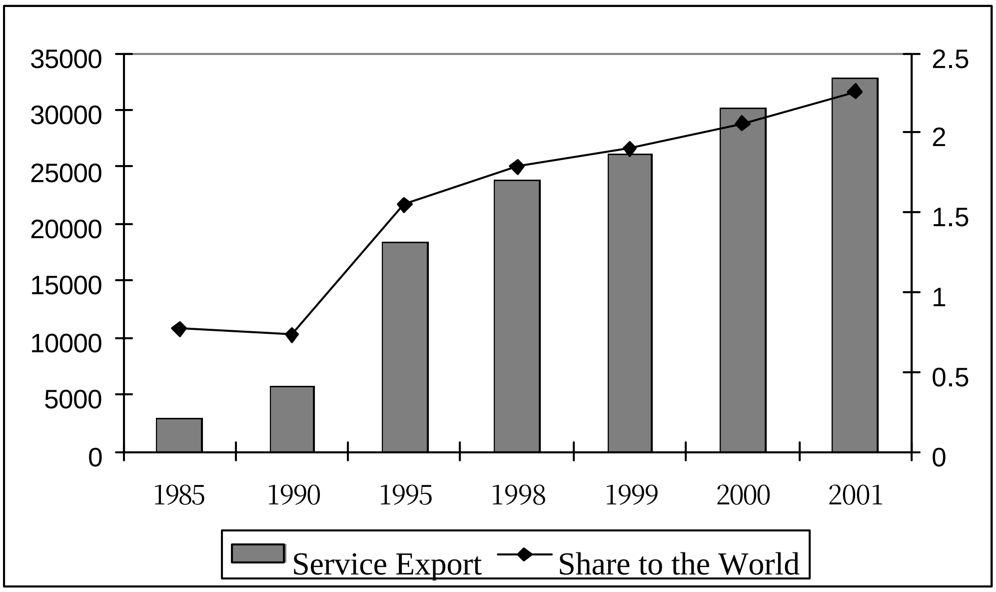
11. China's service trade has been growing steadily with increased share in the world total trade in services. In the past ten years, the annual growth rate of the exports of the trade in services of China was above 9%, which was higher than the world's average. In contrast to the stagnancy of the trade in services world-wide in 2001, China's service export achieved an increase of 9% (See Table 4 and Chart 1).

***Table 4: China's Service Export and Share in the World Total (1985-2001)***
Unit: Million US Dollars

| Year | Service Export | Share in the World Total (%) |
|---|---|---|
| 1985 | 2925 | 0.77 |
| 1990 | 5748 | 0.73 |
| 1995 | 18430 | 1.55 |
| 1998 | 23879 | 1.79 |
| 1999 | 26165 | 1.9 |
| 2000 | 30146 | 2.06 |
| 2001 | 32903 | 2.26 |

Data source: International Trade Statistics, WTO, 2001, 2002

***Chart 1: China's Service Export and its Share in the World Total***
Unit: Million US Dollars




Data source: International Trade Statistics, WTO, 2001 and 2002

12. Compared with trade in goods, China's service export is still at a lower level. The service export only accounted for 11% in the total export in 2001, which was much lower than the average rate of the World 19% (See Table 5). Meanwhile the goods export of China amounted to 4.3% of the world' s total, and the exports of the trade in service only made up 2.3%. These two numbers reveal that China's service export is still under-developed.

***Table 5: Service Exports and Share in China's Total Export and the World as a whole, 2001***

| | Export (Billion US$) | Service Export (Billion US$) | Percentage | |
|---|---|---|---|---|
| | | | Goods Export | Service Export |
| World | 7613 | 1458 | 81 | 19 |
| China | 299 | 33 | 89 | 11 |

Data Source: WTO 2001

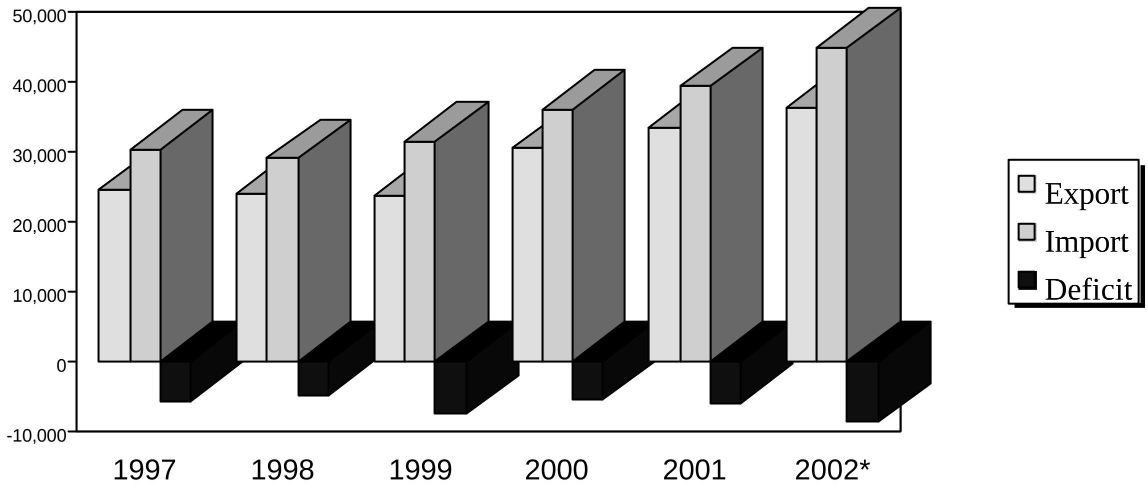
13. On the import side, China has been a net importer of services. China has experienced deficit in service trade for a long time. For the time being, The deficit in services trade appeared from the beginning of 1990s' and the figure increased gradually. In 2001, the services trade deficit amounted to US$ 6.36 billion, and increased to US$ 4.33 billion in the first half of 2002. There is no doubt that the overall services trade deficit in 2002 shall exceed that of 2001 (Table 6 and Chart 2). The tendency of increasing services trade deficit implies that the export capability of China is quite limited. China's export capability is further restricted by trade barriers in some service sectors that China has comparative advantage and competitiveness.

***Table 6: China Service Trade Status, 1985-2001***
Unit: million US$

| Year | Export | Import | Balance |
|---|---|---|---|
| 1985 | 2925 | 2261 | 664 |
| 1990 | 5748 | 4113 | 1635 |
| 1995 | 18430 | 24635 | -6205 |
| 1998 | 23879 | 26467 | -2588 |
| 1999 | 26165 | 30967 | -4802 |
| 2000 | 30146 | 35858 | -5712 |
| 2001 | 32903 | 39260 | -6357 |
| 2002* (Jan-June) | 18099 | 22425 | -4326 |

Data Source: WTO, 2002
*China State Administration of Foreign Exchange, Balance of Payment Sheet, September 2002

***Chart 2. China Trade in Service Deficit, 1997-2002***




Data Source: Balance of Payment Sheet, State Administration of Foreign Exchange, 1997-2002
**The data is an estimated number based on the data collected in the first half of 2002 by the State Administration of Foreign Exchange.*

## 2. Service Industry Became a New Field for FDI after Accession

14. The FDI flowing into China has been increasing stably since 1999 (See Table 7 and Charter 3). Currently, China is one of the leading countries to absorb foreign investment. According to the statistics by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC), 24,771 foreign invested enterprises had been established from January to September this year with the growth rate of 33.4% compared with the same period of last year. The contractual foreign investment amounted to US$ 68.4 billion with the growth rate of 38.4%, and the actual foreign investment amounted to US$ 39.6 billion with the growth rate of 22.6%. By the end of September 2002, altogether 414,796 foreign invested enterprises have been established with contractual and actual FDI of US$ 813.7 billion and US$ 434.8 billion respectively. It is predicted that the overall actual foreign investment in 2002 will exceed US$ 50 billion. After the entry into the WTO, China has made a great stride in terms of absorbing foreign investment due to accelerated opening-up and improved investment environment.

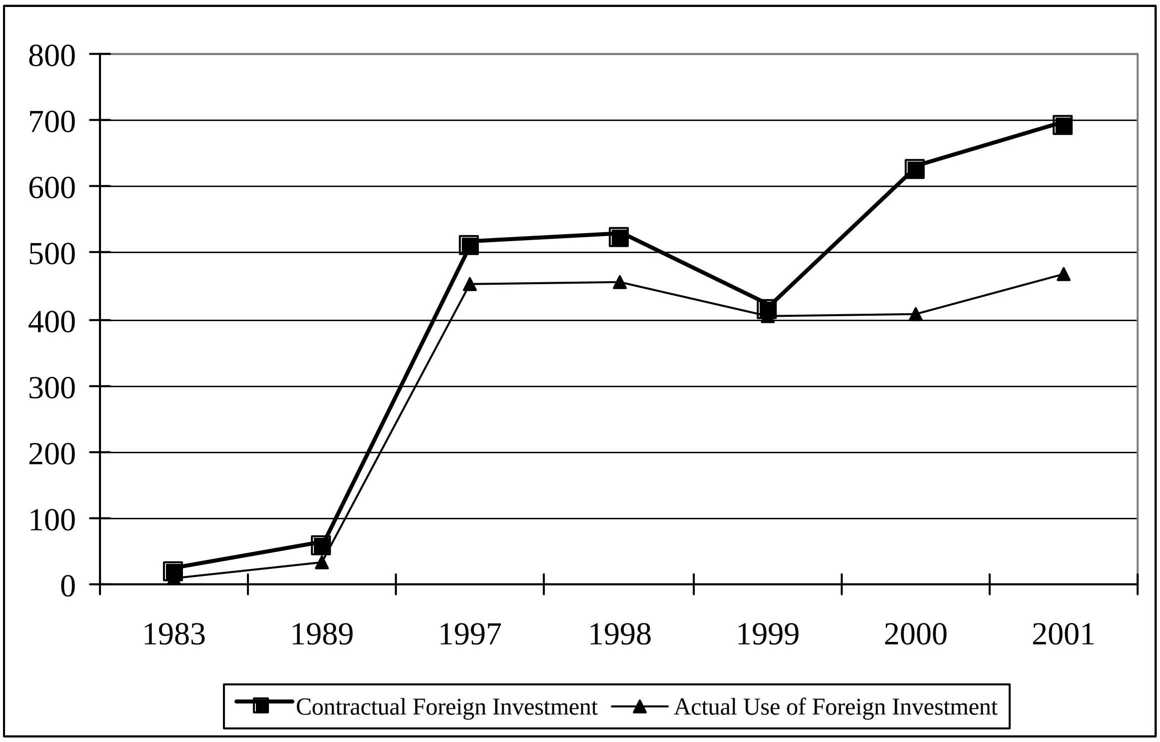
***Table 7: Figures on Foreign Direct Investment (1983-2001)***

Unit：100 million US Dollars

| Year | Contractual Foreign Investment | Actual Utilized Foreign investment |
|---|---|---|
| 1983 | 19.17 | 9.16 |
| 1989 | 56.00 | 33.93 |
| 1997 | 510.03 | 452.57 |
| 1998 | 521.02 | 454.63 |
| 1999 | 412.23 | 403.19 |
| 2000 | 623.80 | 407.15 |
| 2001 | 691.95 | 468.78 |

Data source：Statistics on Foreign Direct Investment, MOFTEC, 2002

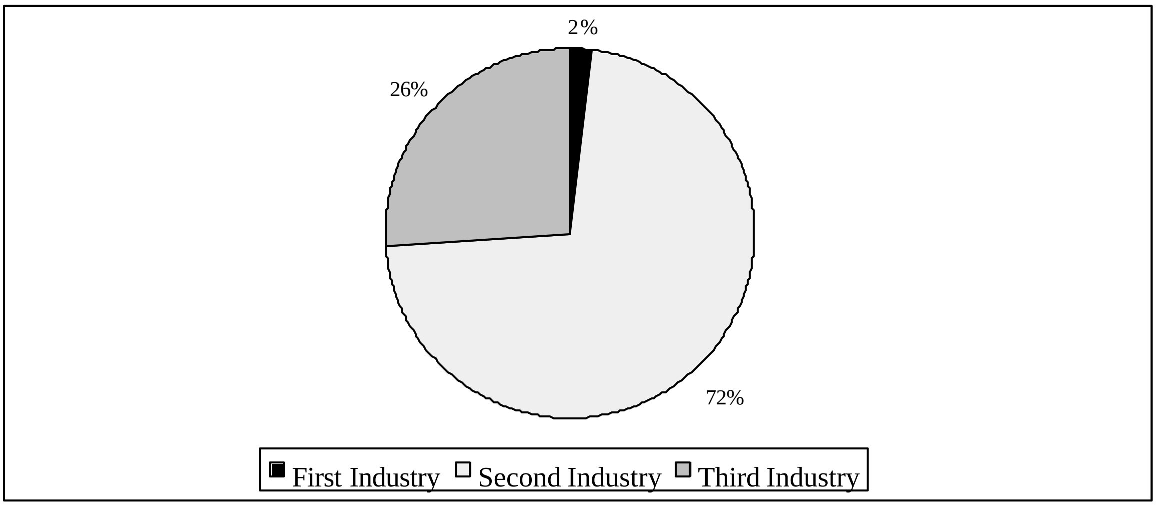
***Chart 3: The development of Foreign Direct Investment in China, 1983-2001***
Unit: 100 million US Dollars




Data source：Statistics on Foreign Direct Investment, MOFTEC, 2002

15. With the development of trade in services, foreign investment in China's services industry increases gradually, which deserves special highlights. In 2001, the investment in services industry accounted for 26% of the total FDI. (See Charter 4)

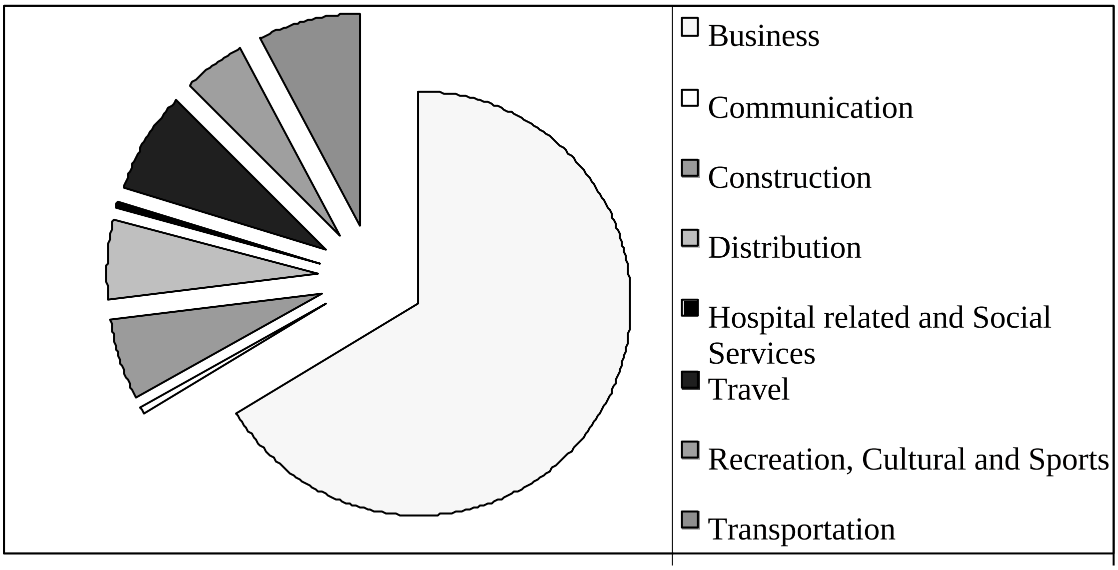
***Chart 4: Proportion of Foreign Investment in Different Industries in 2001***




Data source：Statistics on Foreign Direct Investment, MOFTEC, 2002

16. From January to September 2002, 5801 foreign enterprises were established in the services industry, increased by 27.4% and accounted for 23.4% of the newly established foreign enterprises. In the same period, the contractual foreign investment in this industry amounted to US$ 16.14 billion with the growth rate of 38.6% and accounted for 23.6% of the contractual foreign investment. The actual foreign investment amounted to US$ 9.46 billion with the growth rate of 49.1%, and accounted for 23.9% in the actually utilized foreign investment. The distribution, logistics, medical, educational, cinema, real estate and financial services have been the new fields absorbing more foreign investment. Chart 5 demonstrates the proportion of various services sectors in absorbing foreign capital.

***Chart 5: FDI in Different Service Sectors (January – September, 2002)***




Data source：Statistics on Foreign Direct Investment, MOFTEC, 2002

## III. SUMMARY

17. The progressive liberalization of services in the past decade brings up the following opportunities and challenges for Chinese domestic service industry.

### 1. Opportunities

18. The opening-up helps introduce foreign capital into the services industry that has been short of funds from domestic investors, thus accelerating the development of service industry. One obvious advantage is that in many services sectors, consumers started to enjoy new and better services due to the fast growth of service industry. For example, in the banking sector, loans from the foreign-invested banks have become one of the important channels of foreign capital inflow. By the end of June 2002, the outstanding loans of foreign exchange from foreign-invested banks had reached US$ 18.2 billion. Personal customized banking service, as a new banking service recently introduced by foreign-invested banks has enabled Chinese customers to enjoy more and better banking services besides the traditional personal saving service.

19. The opening-up helps to introduce advanced technologies and management experience from foreign investors and competition mechanism, promote the development and growth of domestic service market, and trained many professionals. Take insurance market as an example, after entering into Shanghai market, AIG (American International Group) introduced world recognized insurance marketing system, stimulated insurance market, strengthen the idea of customer-oriented services of Chinese insurance companies, and promoted the speedy development of personal life insurance

market. Shanghai's total premium increased at an annual rate of 30%, much higher than that of other closed cities. The scenario of expansion of both Chinese and foreign companies has been observed.

20. Liberalization accelerated the process of reform of Stated-Owned Enterprises (SOEs). In order to accommodate the development of Chinese market economy and the competition from foreign service providers, the Chinese government has made its every effort to transform the big wholly-state owned enterprises into state-controlled stock companies by absorbing both foreign and private capital, so as to establish modern structure of corporate governance and to increase competition capacity substantially.

21. China's accession has helped Chinese services providers to tap and get access to international market. After China's accession, awareness of Chinese enterprises to enjoy the right of the WTO and expand services export has been rising. While continuing the exploration of the export advantages in tourism, construction and related engineering services and international maritime services, Chinese enterprises start to "go abroad" in some new service sectors. In insurance services, China People's Insurance Company Inc. (Hong Kong) has just been established last November. This is an important step that Chinese insurance companies have taken to go to overseas insurance market after the accession. In telecommunication services, China Telecommunication Company Inc. (U.S.) had been granted a license to conduct international telecommunication business such as international long distance call between China and the United States, leased line and data services, transmission of TV programs and other business services.

**2. Challenges:**

22. Foreign service providers have grasped more market share in the Chinese services market. In insurance sector, in the city of Shanghai that has been open to foreign insurers as early as 1992, the share of foreign-invested insurance companies in the total market in terms of insurance premium had nearly tripled, increasing from 3.8% in 1994 to 14% in 2000. In another open city of Guangzhou, the life insurance premium income of foreign-invested insurers has taken up 16% in the life insurance market.

23. For advertisement services, up to the end of 2001, there were 46935 advertisement companies in China among which 329 were foreign-invested. In terms of number, foreign-invested advertisement firms only accounted for less that 1%. However, if counted in term of business volume, foreign-invested firms accounted for 20% of the total market. After the accession, foreign-invested firms have been developing even faster. In 2002, 39 new licenses have been issued, which raise the total number of foreign-invested advertising firms to 368, an increase of 11.85% from 2001. On the contrary, the number of domestic advertisement firms was shrinking. It is safe to say that the competition will heat up further more when foreign advertising firms could establish 100% foreign-owned enterprises five years after China's accession.

24. Meanwhile, Chinese small and medium sized enterprises found it difficult to develop their business facing fierce competition from big foreign competitors. Story can be found in the distribution sector. China's biggest retailer, Shanghai Lianhua only had sales volume of US$ 1.7 billion in 2001. This number is less than 1% of that of the U.S. biggest retailer Wal-Mart, which was US$ 200 billion. After China's accession, 28 new foreign-invested retail chain stores have been established, among which 24 stores have operation areas over 10000 square meters. According to the latest statistics from the SETC (State Economic and Trade Commission), foreign department stores take up 6% of the total number. But in the category of big supermarkets, foreign chain stores take up 23% of the total number. This percentage is pretty high compared with that of other service sectors. Though customers could enjoy better services and cheaper merchandize from those big foreign supermarkets, on the other hand many local small retailing stores collapsed. The Chinese government is now facing a challenge of how to deal with the development of small and medium sized enterprises while introducing foreign

competition, since the small and medium sized enterprises are very important to the employment and economic dynamics.

25. The "brain-drain" effect brought by the foreign investment is further amplified. Take legal service as an example, there are altogether 120,000 lawyers and 10,000 law firms in China by 2002, most of which only employ around ten lawyers. The number of law firms that employ more than 100 lawyers is less than 20. Meanwhile fewer than 2000 lawyers, most under the age of 40, are capable of practicing foreign law in foreign languages. They are the backbone of law firms that conduct international legal businesses, however, most of them are employed by representative offices of foreign law firms, which leads to the lack of key personnel in local law firms and indirectly hurts the development of China's legal services industry.

26. The imbalance of economic development between regions will be further widened. With the entry into the WTO, China's investment environment has greatly improved. However, more foreign investments are directed to eastern China, which enjoys a comparative advantage. The gap between the west and the east is further widened. For example, more than 80% of the international law services and large-scale legal service projects are conducted in coastal cities and Beijing. Last year, more than 1/4 of the total income of China's legal sector derived from Beijing and Shanghai only. Meanwhile, a large number of law firms in the vast area of western China hardly made any profits.

27. The deficit in services trade has a negative impact on the balance of payments of China. According to the statistics provided by the State Administration of Foreign Exchange, the deficit in China's services trade will reach a record high of US$ 8 billion by the end of 2002, an increase of more than 30% compared with last year. Looking into the data of the last few years, we can find that while the surplus of China's goods trade is diminishing, the deficit in services trade is in a dramatic increase, which in the long term will deteriorate China's balance of payments situation.

## 3. Preliminary conclusions

28. Before the opening-up, China pursued a planned economic system and the importance of services industry in the national economy was ignored to a large extent. After the introduction of economic reform and opening-up, although China's services industry has developed rapidly, there still exists a great gap between services industry of China and that of many other WTO members. Therefore, China's services industry lacks competitive edge in international market. Generally speaking, some of China's services industries are still at its infancy and the infrastructure is in an urgent need of strengthening, thus the government has to attach great importance to the following aspects in the process of liberalizing its service trade:

29. **Strengthening the legal framework.** In some service sectors of China, the basic governing laws were just enacted and some are still under drafting. The Insurance Law was revised recently. The Postal Law is still in the revision process, while the drafting of The Telecommunication Law is still under way. Many important laws related to foreign investment were just enacted upon China's accession. The insufficiency of laws and regulations pose many difficulties not only to the business operation of foreign service suppliers, but also to the opening-up process and governmental administration. However, for a developing country like China, the enactment of law is never an easy task, while the constant changes of service market make it more difficult.

30. **Building up regulatory capacity.** As stated before, in many service sectors, the governing laws and regulations have not yet taken shape. The competent authorities lack both experience and regulatory capacity. Under these circumstances, the opening-up may lead to market disorder and therefore calls for necessary regulation by the government.

31. **Providing "breathing space" for the reform of state-owned enterprises.** At present, the reform of state-owned enterprises has entered into a crucial period. In order to standup to the challenges brought about by market opening and competition from foreign service suppliers, this reform is inevitable. However it takes time, especially for the SOEs in the financial sector (see paragraph 51 of Part IV).

32. Therefore, China believes the liberalization of trade in services should be progressive and managed.

## IV. CASE STUDY: OPENING-UP OF CHINA'S BANKING SERVICES

### 1. Current Situation of China's Banking Sector

33. At present, the state-owned commercial banks take a leading position in China's banking sector, while at the same time the joint-stock banks and foreign-funded banks become more and more active in the arena. By the end of October 2002, the market structure in the banking sector is as follows: three policy banks, four state-owned commercial banks, 11 joint-stock commercial banks, 112 city commercial banks, approximately 38,000 rural credit cooperatives and 180 foreign-funded operational banking institutions. By the end of 2001, the total assets of financial institutions amounted to RMB 21.7 trillion (not including the securities and insurance institutions).

34. Before 1995, People's Bank of China, the central bank of China was the sole regulator of China's financial market. In 1995, for prudential consideration, China decided to adopt a segregated regulatory framework in its financial system, which led to the establishment of two new regulatory authorities, namely China Securities Regulatory Commission, and China Insurance Regulatory Commission, which are responsible for supervising the securities and insurance sectors respectively, while the People's Bank of China remains as the regulator of the banking sector. After this systemic adjustment, China's capacity to regulate the financial market and keep away financial risks and crises has been remarkably improved.

### 2. The Opening-up Process of China's Banking Sector

35. This process could be characterized into the following four stages.

36. **Stage one: Foreign banks were allowed to set up non-operational institutions (i.e. representative offices) in China.** In 1979, the representative office of Japan Export and Import Bank was established in Beijing, which was the first representative office of foreign banks in China.

37. **Stage two: Foreign banks were allowed to set up operational institutions.** In July 1981, foreign banks were allowed to conduct foreign exchange business in Shenzhen and other three Special Economic Zones; in September 1990, Shanghai became the first coastal city opened to foreign banks following five Special Economic Zones. Starting from 1992, the opening area was further expanded to other seven coastal cities. In January 1999, the geographic restrictions on the establishment of foreign banks were lifted and foreign banks were allowed to conduct business in all main cities of China.

38. **Stage three: Foreign banks are allowed to conduct the local currency business on a pilot basis.** In December 1996, foreign banks in Pudong, Shanghai were allowed to conduct RMB business after meeting certain conditions. In August 1998, the same treatment was granted to the foreign banks in Shenzhen.

39. **Stage four: Overall opening-up of China's banking sector.** Within two years after China's accession, foreign banks will be allowed to provide local currency business to domestic-funded enterprises. Within five years after accession, they will be allowed to provide business to all Chinese

residents. The liberalization at this stage is more substantive than the previous ones. Starting from 11 December 2001, foreign banks are allowed to conduct foreign currency business to all kinds of clients without geographic restrictions. Currently, foreign banks may conduct RMB business in Shanghai, Tianjin, Shenzhen and Dalian. By the end of 2002, the opening area will be expanded to Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan. For the following four years, more cities will be opened by end of each year till the end of 2006, when all the geographic restrictions on foreign banks will be eliminated.

40. With the deepening of China's reform and opening-up process, foreign banks accelerated their entrance into China's banking market. By September 2002, there were altogether 384 foreign banking institutions in China, including 180 operational entities from 20 countries/regions, among which 147 were foreign bank branches and eight were sub-branches. Meanwhile foreign banks from 37 countries/regions have set up 204 representative offices in China.

41. By the end of 2001, the aggregate assets of foreign banks in china constituted 1.52% of the aggregate assets of China's banking sector. However, foreign exchange loans issued by foreign banks constituted 20% of the aggregate amount of the foreign exchange loans issued by all the banking institutions in China. Taking into account the small share of the assets of foreign banks and the fact that foreign banks were only allowed to conduct foreign exchange business by 2001, foreign banks in China have developed very fast. Nevertheless, the expansion of foreign banks will be further accelerated with the phasing-in of China's accession commitments. Since December 2001, China has opened the local currency business to foreign banks partially. By October 2002, the local currency assets of foreign banks amounted to RMB 47.8 billion, and the aggregate outstanding local currency loan was RMB 38.5 billion.

42. During the above-mentioned liberalization process, the regulatory framework of China's banking sector has been gradually reformed and reinforced in consistency with international practices. While keeping consistent with domestic specific situation, People's Bank of China has absorbed as many as possible reasonable proposals on investment from the Basel Committee to administer and regulate the access of institution, business scope and personnel of foreign banks based on prudential principles.

### 3. The Opportunities and Challenges of the Opening-up

(a) Opportunities:

43. **Increasing foreign capital inflows and improving the investment environment.** By June 2002, foreign exchange loans issued by foreign banks amounted to US$ 18.2 billion, among which 80% were loans to domestic enterprises and 70% were financed by means of lending from parent banks or international financial markets. Foreign banks have become important channels of bringing in foreign capitals. More participation of foreign banks into China's market is improving the function of financial system and provides more advanced services to all consumers in China.

44. **Facilitating reforms in banking system, promoting the competitiveness of domestic banks.** Most foreign banks investing in China have long history of development in their home markets. They bring into China's financial market ample experiences in corporate governance, risk management, internal controlling, incentive mechanism, business innovation, market exploration and accounting system. All these exert strong pressure on China's domestic banks that must take concrete measures to deepen their systematic reforms and enhance their competitiveness.

45. **Creating opportunities for domestic-funded banks' exploration of international financial markets.** While foreign banks have more access to Chinese market, Chinese banks are also accelerating their pace to "go abroad". Though at a much slower speed compared with foreign banks,

China had set up more than 90 branches and representative offices in overseas market, including Hong Kong China.

(b) Challenges:

46. **Domestic banks are losing market share and high-end consumers.** Statistics show that, in banking sector, 80% of the profits come from 20% of the high-end consumers. With the business expansion of foreign banks, certain portion of consumers, especially those high-end clients start to turn to foreign banks due to fierce competition.

47. **Domestic banks are losing capable executives.** The more flexible and transparent promotion and incentive mechanism of foreign banks are of great attractiveness to many experienced senior executives and key personnel in domestic banks, which leads to a certain "brain-drain" effect in the sector.

48. **The banking regulator is under harder pressure in macro-regulation of financial system and the implementation of central bank functions.** With further opening-up, the fluctuations of world economies, through international trade and other channels, will affect China's domestic economic performance to a larger extent. As more foreign banks expand their business in China, the exchange between local currency and foreign currencies will increase dramatically and bring about more frequent inflows and outflows of international capitals, which in turn will have greater impact on the implementation of China's monetary policy. Accordingly the macro-regulatory mechanism of financial market is facing more challenges.

**4. Preliminary Conclusions**

49. According to China's accession commitments in banking sector, at the end point of phasing-in period (five years after accession), the limitations on local currency business and on consumers will be fully eliminated. When this assessment report is drafted, the implementation of China's commitments only enters into the second year. Therefore it's still too early to make a final conclusion of the impact of the full implementation of China's commitments on China's banking sector. However, some preliminary conclusions could be drawn form the above analysis.

50. Compared with developed members, China's banking sector is still in the process of continuous reform and further improvement. A financial system conducive to the market economy is just taking shape and domestic banks still lack competitive edge. The administrative capacity of the regulatory authority still falls far behind that of many of its counterparts in developed members. With the rapid expansion of foreign banks in the market, the financial innovations are accelerated; transaction techniques become more complicated and China's financial institutions are experiencing tremendous changes. These in turn increase the risks and instabilities of the market and add more difficulties and costs to financial administration.

51. The non-performing loan (NPL) is one of the major concerns of Chinese domestic banks, particularly of four big stated-owned banks. Our goal is that within five years, the ratio of NPL will be decreased to 15%, which coincides with five-year phase-in period in China's commitments on banking services. The major issues to be addressed include corporate governance, capital sufficiency, restructure and streamline of the branches and subordinate bodies. The fulfillment of these goals is also a time-consuming process. Therefore, we deem it necessary to make liberalization a progressive process that should keep pace with the reform of state-owned commercial banks. In other words, the liberalization process and domestic financial reform process should be mutually reinforced (Mattoo, 2002).

52. In conclusion, liberalization of the banking sector has played a role in improving the function of China's financial system. Therefore, the process will keep going on in China. Meanwhile, from the perspectives of regulation, reform and market development, a gradual liberalization process is of the utmost importance to China's banking sector.

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