

THE IMPACT OF CHINA'S WTO ACCESSION ON CAPITAL FREEDOM

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The World Trade Organization focuses primarily on exchanges among nations of goods and services — i.e., the outputs of firms and households. Capital is, of course, a factor of production, which means it is an input. If this was the whole story, then conformity to WTO rules on competition, openness, lack of government subsidies, etc., would require China's outputs to be competitively priced. To maximize benefits, China would find it necessary to supply goods and services through transparent, competitive markets. Hence, although WTO membership does not explicitly mandate open, efficient capital markets, China would be implicitly required to do so in order to attain the full benefits of membership. However, membership requirements do go further: in particular they require the financial sector to be opened to foreign competition within five years of accession. In effect, membership in the WTO implies membership in a global community that subscribes to the operation of free, private markets not only in goods and services but also in the underlying factor markets.

In this paper, I discuss China's capital markets under two main headings: domestic and international. The latter includes any capital flows that should properly be recorded in China's international balance of payments. As soon as China joins the WTO and agrees to a program of rapid tariff reductions to comply with WTO rules, a series of pressures or even shocks will start to be imposed on Chinese mainland industries and firms, which will require urgent, concurrent structural reforms. WTO membership, therefore, will intensify the need to become internationally competitive and increase the pressure for domestic structural reform, which implies a radical shake-up of China's capital markets.

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I start with the international aspects of China's capital flows and their implications for capital markets, monetary policy, and the exchange rate regime, and then turn to discuss the state of China's domestic equity and bank credit markets, and the desperate need for reform in these two areas.

China's International Balance of Payments and Capital Flows under WTO Membership

The current structure of China's balance of payments is unusual for a developing country. China typically runs a surplus on current account that has averaged 2 to 3 percent of GDP during the 1990s. The surplus on current account finances a net capital outflow that can broadly be split into three main components. First, there are the substantial net private inflows of foreign direct investment (FDI) that are almost exactly offset by private outflows on portfolio and other investment accounts. These latter are mainly trade credits and repayment of bank loans or other long-term borrowings. The second component is the accumulation of large official foreign exchange reserves by the government through the People's Bank of China. The third component is the persistent unrecorded capital outflow by the private sector. These outflows may partly be the result of illegal or underhand transactions such as transfer pricing, e.g., overinvoicing of imports or underinvoicing of exports, or the smuggling out of the proceeds of corruption and crime. In the past decade, these unrecorded capital flows—reflected in the large errors and omissions terms in China's balance of payments—have increased strikingly.

It might be said that this third type of capital outflow is undesirable. However, such a judgment does not take into account the capital controls, distortions, or other perverse incentives facing Chinese mainland residents. Even if some of the unrecorded capital outflow is legitimate, there is still the question of whether China as a developing country should really be exporting capital on this scale. In addition, it is questionable whether the authorities should be accumulating foreign exchange reserves on such a large scale. It could imply that the foreign exchange rate is undervalued, and this could lead to monetary control problems at some stage in the future. Just as important, the accumulation of foreign assets by the government in place of the private sector amounts to the backdoor nationalization of what would otherwise have been potentially profitable overseas investments by private individuals and businesses. (A good example of

this kind of misallocation and its destabilizing effects on the domestic monetary system is the case of Taiwan in the second half of the 1980s.)

Leaving aside the undesirability of these kinds of capital outflows, at a more fundamental level it is undesirable and inappropriate that a country with such a low per capita income as China—a capital poor country—should be exporting capital. If China's capital markets and its industries were normalized (through deregulation, proper implementation of the rule of law, the encouragement of private markets, and extensive private ownership), then China's balance of payments would no doubt undergo a major transformation. The balance of payments would witness a switch from current account surplus and capital outflows to current account deficit and capital inflows. This would be consistent with more traditional patterns for other rapidly developing economies in the Asia-Pacific region.

Yet, such a transformation is hardly conceivable without significant internal and external adjustments. Under one possible scenario, deregulation of China's domestic capital markets could be initiated along with the adoption of a progressively more flexible nominal exchange rate regime. Although the experience of other Asian economies during a period of interest rate or capital market deregulation has not always been compatible with external exchange rate stability, financial market liberalization need not be destabilizing. A crucial ingredient of exchange rate crises in the developing Asian economies has been domestic monetary instability associated with deregulation (e.g., Thailand in the years 1993–97). Provided China could avoid such monetary instability, the prospects of accomplishing the transformation in the external accounts would be much enhanced under a more flexible exchange rate regime. Over time it would be necessary for the foreign exchange rate for the RMB to appreciate. This would cause a gradual reduction in exports (through competitive price pressures on exporting industries) and conversely would increase imports.

A second option is for the foreign exchange rate to be held fixed in nominal terms against the U.S. dollar while the internal capital market deregulation is implemented. The major risk under this scenario is that the deregulation could lead to either episodes of strong capital inflows (leading to monetary expansion followed by inflation), or episodes of capital outflows (leading to monetary contraction and deflation). Between 1978 and 1993, China experienced this kind of stop-go cycle, though without far-reaching capital market deregulation. Under a fixed nominal rate framework, external capital controls are much more likely to be maintained and the adjustments to the trade

and current account are therefore much less likely to occur. Every time China's exports started to become less competitive, or imports expanded, there would be political pressures to slow down the restructuring process. Thus, external account adjustment would be painful and extended, and might ultimately fail to be accomplished.

China, therefore, faces a simple choice: persist with the current wasteful distortions to capital flows and deny the country much-needed capital for development to raise living standards, or gradually eliminate the distortions to allow foreign capital, technology, and management skills to enter the country and speed up the pace of development. Insofar as WTO accession will compel China to address these issues over quite a short timeframe, we should expect major developments in this area over the next five years.

To see how China could develop with a fixed nominal exchange rate, it is instructive to study the experience of Japan between 1949 and 1971. In April 1949, Japan fixed the Yen-dollar exchange rate at Yen 360 per dollar, and maintained it at that level for the next 22 years. This was followed by substantial liberalization of trade as Japan prepared for membership in the GATT (the WTO's predecessor organization), which it attained in 1964. However, partial capital controls were maintained until well into the 1970s and 1980s. For example, Japan maintained varying percentage limits on foreign ownership of Japanese listed and nonlisted equities, balance sheet controls on overseas investment by Japanese financial institutions, detailed "window guidance" on lending and investment by Japanese banks, and nontariff protection of a wide range of industries.

During these years Japanese real GDP averaged 8 to 9 percent per annum, though there were wide fluctuations. These occurred primarily as a result of monetary instability resulting from monetary accelerations and decelerations in response to the impact of changes in the overall balance of payments at the fixed exchange rate. Overall balance of payments surpluses led to monetary expansions followed by business booms, and subsequently a rise in inflation. Once the price level had exceeded the U.S. price level, Japanese firms began to become less competitive, exports slowed, imports picked up, and the overall balance of payments swung back towards deficit, sending the whole process into reverse. Ultimately, an overall balance of payments deficit produced a monetary tightening, followed by an economic downturn and a slowdown in the rate of inflation. Once Japanese prices had fallen below U.S. price levels, Japanese firms became more competitive again, exports expanded, and imports slowed until the overall balance of payments reverted to surplus and the whole cycle started over again.

As mentioned above, China began to exhibit this kind of stop-go pattern of economic development in the period 1978–93. However, the external exchange rate was repeatedly adjusted and since the mid-1990s the regular business cycle appears to have been interrupted by an extended period of monetary restraint followed by a two-year episode of deflation.

The alternative development path is for China to proceed with a more variable exchange rate policy, allowing the exchange rate to adjust to keep the domestic economy on a stable course. Such a path is theoretically feasible, but in practice much more difficult to implement successfully. In particular, it will require a much more developed domestic capital market, combined with sophisticated monetary tools to maintain monetary stability in China. Yet, the current consensus among China analysts suggests this is the likely course of official policy in the early years after joining the WTO.

One advantage of this second path is that it would enable China to absorb external and internal shocks with less disruption. For example, with economic and financial liberalization, it is likely that China's gross domestic savings rate is likely to undergo significant changes. In Japan's case, the savings rate rose steadily through the 1950s and 1960s, which coincidentally meant that Japan did not need as much capital inflow as it would otherwise have needed. Hence, the major disturbances to Japan's balance of payments at the fixed exchange rate came mainly from changes in the trade and current accounts, rather than from the capital accounts. But in China's case, we cannot know *ex ante* how China's savings rate will behave in the aftermath of WTO accession, so a more variable exchange rate would be an elegant way to minimize disruptions from changes in the savings rate while at the same time helping to achieve the transformation from current account surplus and capital outflow to current account deficit and capital inflow.

China's Domestic Capital Markets

China's economy needs to grow to satisfy the aspirations of its people for higher living standards, but growth requires investment, and investment can only come from domestic and foreign savings. The challenge, therefore, is how to mobilize savings and how to allocate them most efficiently among different investment opportunities. At present, although the state-owned enterprises (SOEs) have a diminishing role in the economy, they still account for the lion's share of investment funds (equity and debt combined).

One way to start thinking about China's domestic capital markets is to consider the limited menu of options facing an individual saver. How can he or she deploy his or her savings? There are currently about five options: (1) invest in the equity (A shares) of some of the 860 or so SOEs listed on China's two stock exchanges, (2) deposit money with a state-owned bank and earn a modest interest return, (3) purchase government bonds, (4) purchase a life insurance contract, or (5) purchase a home, usually with the help of a loan from a bank. Viewed from the demand side, there is potentially a vast array of investment opportunities in China seeking capital. But savings will not flow to them unless radical steps are taken to open the markets. China's WTO accession provides exactly such an opportunity.

The following paragraphs provide a brief sketch of some of China's capital markets on the eve of WTO accession. The various segments of the capital markets are hard to treat as an integrated whole because that is not the way they have been viewed or allowed to develop by the Chinese authorities. The markets are segmented, compartmentalized, and subject to a variety of industry-specific controls. Prior to the reforms of the 1980s and the creation of the two stock exchanges in Shanghai and Shenzhen, access to capital was in effect restricted to central, provincial, and local government entities, SOEs, township and village enterprises (TVEs), and some small enterprises. Individuals and enterprises outside the scope of government supervision were effectively denied access to capital. This tradition of central control still persists. Even today, access to capital is a privilege granted by government, rather than a matter of open, competitive access. Although access to equity funding has been widened considerably by the formation of formalized equity markets, administrative and regulatory controls and a queueing system for new issues mean that it is far from easy for an entrepreneur or a company to go to the market for additional equity funds.

Equity Markets

From the early days of economic reform in the 1980s until the recent past, the stock exchanges were viewed as a supplementary way for SOEs to raise funds. The SOEs were deemed the desirable model of future growth and development of conglomerates, based on the *chaebols* of South Korea. The listed SOEs were viewed as the major vehicles for raising capital and generating output, but being largely state-owned they have run into huge problems of bad governance, which in turn has meant large-scale misallocation of capital and wasted output. If we take the H-share companies as an example, most

were only able to maintain one or two years of profitability after their IPOs. It is interesting to note that the SOE problems are of relatively recent origin, with 70 percent of them having been established within the last two decades (i.e., during the period of economic reform). Most SOEs were set up by local governments catering to local interests and especially to provide tax revenue to local governments and employment to the local population. Since many provinces wanted their own airlines, auto plants, iron and steel industry, and so on, massive excess capacity quickly resulted. Thus, in the auto market China had hundreds of automakers while the United States only has three. Inevitably China's SOEs tend to produce low value-added goods and employ large numbers of people, but since firms have been the channel for the distribution of education, medical, housing, and retirement benefits, these overheads bite deep into profits. With increased competition at home and increased competition from abroad after WTO entry, these SOEs are going to come under intense pressure to perform.

China's progress in economic reform as it affects the listed equity markets can be categorized into four main stages. Stage 1 was characterized by FDI in the coastal regions and later in the SEZs by compatriot investors, primarily from Hong Kong and Taiwan. Later, joint ventures were started and wholly owned investments were made by investors from developed countries such as Japan, North America, and Europe. National (or racial) preference for FDI by overseas Chinese nationals was the rule—reminiscent of the preference shown by India toward NRIs (non-resident Indians)—and can still be seen in China today for sensitive sectors. For example, at Beidaihe in August 2000, President Jiang Zemin addressed the question of foreign investment in the media and telecommunications sectors consequent upon China's accession to the WTO. Newspaper reports explain:

To counter an invasion of anti-socialist or bourgeois-liberal ideas, more media organizations would be asked to undergo government controlled mergers to ensure control by party and government censors . . . After WTO entry the Jiang leadership will continue to place formal and hidden restrictions on media units' use of foreign funds as well as the content produced by the joint ventures . . . Mr. Jiang and his colleagues have indicated that after WTO accession they will favour absorbing capital from ethnic Chinese sources, including the SAR and Taiwan, for sensitive fields such as media and telecommunications [Lam 2000: 6].

Stage 2 in the development of equity markets was the flotation of A shares in Shanghai and Shenzhen to raise funds from the domestic market, and B shares to raise funds from overseas. Stage 3 saw the

listing of H shares in Hong Kong and N shares in New York. By and large the performance of companies and shares on these markets was, with few exceptions, a major disappointment. Some members of the Chinese leadership appeared to grasp the gravity of the problem. During this phase the response was to attempt top-down, government-orchestrated mergers or arranged marriages such as the 1997 mergers that formed China's two petrochemical giants, Sinopec and CNPC. The problem is that merging two or more large, inefficient state-owned companies only creates one even larger, potentially more inefficient company and does nothing to change the incentives governing the behavior of directors, managers, and employees. State ownership necessarily implies problems in implementing good governance, but state-ownership is pervasive both among China's listed companies and in its nonlisted sector.

The approach involving compulsory merger of SOEs is not quite dead yet, but there have been some examples of a different approach in recent months—namely toward freer marriages where the partners select each other (such as the recently announced merger between Huaneng International Power and Shandong International). Perhaps as a result of the failed SOE mergers in recent years there has in the past year or so been a welcome change of direction by the authorities. Their attitudes toward restructuring have become altogether more serious. Flotations, they have understood, cannot be aimed at simply raising money for a one-period game following which the managers and directors disappear and avoid any accountability. Capital markets demand time-consistent behavior, which implies continuous attention to shareholders' interests—not merely at the time of the IPO.

If Stage 4 embodies these new attitudes, China could make a new start. Over the next two years a series of privatizations (listings) is planned for some of China's major strategic industries. Petrochina, previously the largest SOE in China with a near-monopoly of on-shore oil and gas extraction and a leader in downstream refining and distribution, is perhaps the outstanding example of this new attitude. It has been radically restructured, its business model revamped, incentives provided to management, and it is in discussion with possible overseas partners. Investors can only wait and see.

Debt Markets

The debt markets in China are principally the markets for bank loans and central and provincial government debt. Here I will only discuss the market for bank credit as the corporate bond market remains virtually undeveloped.

Outwardly China has banks, insurance companies, trust companies, and a variety of local savings cooperatives and nonbank banks. But if we look inside these organizations, none of the incentives that drove comparable western institutions to growth, profits, innovation, and risk-taking exist in the case of the Chinese institutions. State or collective ownership completely undermines good governance; it eliminates the incentives for a bank manager to take risks and lend to start-up private companies because there is no upside reward to that manager. This means that bankers in a state-owned system are basically bureaucrats following either the state credit plan, or the instructions of some political superior, instead of being the custodians of the bank's equity and deposit funds, seeking profitable lending opportunities on behalf of shareholders. At the same time the weakness of the legal framework means that there is little means of enforcement of penalties for abuse of stewardship. Little wonder then that China's bank reform plan has stalled.

Like banks elsewhere in Asia, China's banks have made loans to companies (mainly SOEs) that now cannot be repaid. Half of these nonperforming loans on the books of the banks have been placed in the hands of asset management companies (AMCs). But unlike the Resolution Trust Company in the United States in the early 1990s, the Chinese AMCs are finding that they cannot sell down the loans that they have taken over. Either there is no market or they are constrained to meet a 70 percent payback target. In effect, all that has happened is that the debts of the SOEs have been forgiven, the banks' balance sheets have been temporarily cleaned up, and the government or taxpayer has been left with the worthless loan. Following a large debt-for-equity swap earlier this year, the banks, it was said, would henceforth lend only on a commercial basis. But the key to a bank bailout is liquidating the bad assets by sale at market values to those who have sufficient equity to buy and utilize them. This may require the creation of a market in distressed financial assets, and it may also require a market in the underlying collateral (such as real estate). Neither of these two developments have occurred in China. Thus, the bankers have not had to suffer the consequences of their reckless lending to SOEs or to the real estate sector, and the creation of the AMCs has simply added another layer of moral hazard to China's banking system.

Conclusion

Until there is a high degree of private ownership and consequently improved governance, transparent accounting, attention to share-

holder value, and properly accountable management in China's financial sector, it is hard to see the reforms announced and implemented so far making much progress. One of the major benefits of China's WTO accession will be that it accelerates these much-needed financial reforms.

Reference

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