

The Challenges of WTO entry to China's banking industry

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List of Abbreviations

ABC	Agricultural Bank of China
BOC	Bank of China
BOCAR	BOC Annual Reports
BoCOM	Bank of Communications
CBRC	China Banking Regulatory Commission
CCB	China Construction Bank
HSBC	Hongkong and Shanghai Banking Corporation
ICBC	Industrial and Commercial Bank of China
IT	Information Technology
M&A	Merger & Acquisition
NPLs	Non-Performing Loans
RMB	Renminbi (currency of People's Republic of China)
ROA	Return on Assets
ROE	Return on Equities
SOE	State-Owned Enterprises

Introduction

The 1997 Asian Financial Crisis adversely impacted countries like South Korea, Thailand, and Indonesia, and especially exposed the serious problems in their banking systems. China was not engulfed in this crisis and maintained relatively sound economic performance. However, China has many of the same banking problems as its neighbors, most notably, the bank-dominated financial system, highly-leveraged enterprises, excessive lending, and huge build-up of bad debts (Lardy 1998). During recent years, despite many efforts at different levels and various reform packages, China's banking system is still problematic. And Chinese banks face challenges of poor corporate governance, unwarranted government intervention, and rampant banking crimes. What's more, China's WTO entry is opening China's banking sector to the outside world, and directly changing the competition pattern in China's financial market.

This paper tries to analyze the Challenges of WTO entry to China's banking industry. It first gives a brief introduction to the background and significance of the WTO agreement, and then discusses the global business revolution and its huge impact on global banking industry. Afterwards, the paper focuses on comparison of competitiveness between foreign and Chinese banks. Furthermore, the paper examines the different characteristics between the current round of banking competition in

China and the pre-1949 one, and finally draws some conclusions.

WTO agreement

Since the late 1970s, China began to gradually open up its banking sector. Attracted by the fast growing economy, huge potential market and a 40% household savings rate, more and more foreign banks are tapping business in China. So far, almost all global big names have established presence in China, like Citigroup, HSBC, Deutsche Bank, Bank of America, Credit Suisse, and Standard Chartered Bank, etc. As of end-October 2005, China's banking system consisted of 238 operational entities of foreign bank (138 can do RMB business) (CBRC 2005). The total assets of foreign banks in China amounted to USD84.5 billion compared with USD53.6 billion in 2004 and USD29 billion in 1996. Foreign banks can offer around 100 types of products and services under 12 broad categories of business activity (ibid).

In particular, the China-US WTO Agreement in 2001 is a milestone in China's history. According to the commitment of WTO, all geographic and customer restrictions regarding foreign banks will be removed within five years. China has agreed to allow foreign banks to undertake local currency business with Chinese enterprises within two years of accession, and to allow local currency business with individuals from five years

after accession. By the end of 2006, China's banking sector will be completely open, and foreign banks are able to enjoy full national treatment (Caijing 29 November 2004).

American Trade Representative Charlene Barshefsky commented that the changes to be unleashed by China's WTO accession would be 'profoundly important' (Barshefsky 1999). In other words, accession will shake China to its foundations. The Director-General of WTO remarked: 'Chinese banks will, for the first time, face real competition' (Panitchpakdi 2002: 168). Again, renowned Chinese economist Li Yining alerted us, 'This time the wolves really are coming' (Financial Times 2 November 2002).

The wisdom from ancient Chinese strategist Sun Tzu is – 'If ignorant both of your enemy and yourself, you are certain to be in peril'. How powerful and aggressive are these wolves? What is the comparison of power between China's banks and foreign counterparts?

Globalization and financial business revolution

The period since the 1980s has seen a revolution in global business systems (Nolan 2001). The globalization has created a huge demand for world-wide financial services, and great opportunities for financial

institutions to expand globally. Simultaneously, deregulation, particularly abolishment of the Glass-Steagall Act in US made it possible for aggressive financial institutions to take cross-sector transactions. Leading financial service firms, all from the high-income economies, have been through a period of unprecedented M&A (merger and acquisition). A major motive is to provide a global service to customers who themselves increasingly operate on a global basis, as well as acquiring new customers in other countries. A further driving force is the need to distribute the risk internationally. The dramatic development of information technology (IT) has radically increased the possibility of operating a bank on a global scale (Wu 2001).

Under this background, the mantra has become ‘bigger is better’ (Haddock 2000). From 1989 to 1999, there were estimated 3844 M&A in the global banking industry, with the acquiring institutions purchasing more than USD3 trillion in assets (Wu 2001:815). This latest merger wave has been characterized by among ‘very large corporations’ (Singh 1992:4). In late 1990s, the tie-up between Citicorp and Travelers has enabled the new Citigroup to move into new areas with new customers. In 2000, a Wall Street powerhouse – JP Morgan Chase was created by blending Chase’s balance sheet muscle and JP Morgan’s investment banking talent. After 2000, there are rising mega-mergers. Year 2004

witnessed two giant steps in banking consolidation with the mergers of JPMorgan with Bank One and Bank of America with Fleet Boston (The Banker 3 February 2004). In Europe, France's Crédit Agricole Group took over Crédit Lyonnais, and the Royal Bank of Scotland acquired Charter One of the US (The Banker 2004). At the beginning of 2006, the finalized merger between Japan's Mitsubishi Tokyo Financial Group and UFJ Holdings has upgraded it to the biggest bank in the world, boasting total assets of USD1400 billion (Caijing 23 January 2006). Most significantly, BSCH, Spain's largest banking group, took over Britain's Abbey National bank (BBC 26 July 2004), and UniCredit (Italy) recently acquired Germany's Hypovereinsbank (The Banker 2005). These takeovers may trigger the start of the long-awaited surge in European cross-border mergers.

This trend for consolidation can be seen in the larger size of the banks in the Top 1000 (The Banker 2004). In 2003, aggregate total assets rose significantly, by 19.3% to USD 52,391 billion from previous year, indicating the growth in banking assets in this new expansionary phase (ibid). The Top 25 giants are taking an increasingly large slice of the overall banking pie and they continue to expand and account for 37.06% of the aggregate total assets of the Top 1000, a significant increase on the 31.08% in the 1995 listing. Among them, six banks (Mizuho Financial

Group, Citigroup, UBS, Crédit Agricole, HSBC and Deutsche) reported respective assets in excess of USD1000 billion (The Banker 2004). Boston Consulting Group exclaimed a new era: the age of the banking titans. 'We expect the banking titans, by their presence alone, to exert influence on the strategy of other global players. Focusing on operations that are subscale compared with the titans and following slow organic growth strategies are unlikely to guarantee independence anymore. A new challenge for top management is to survive successfully in the age of banking titans' (quoted in The Banker 2004). These banking titans are not only big, they are extremely strong. They enjoy benefits of economies of scale and scope, global reputation, low cost, sophisticated IT systems, international branding, high quality human resources, and high level of technical expertise. They are 'clearly creating a separate strata of their own and look set to take over growing segments of the global banking market' (The Banker 2005).

Indeed, global giants are taking every opportunity to penetrate into the developing countries. They not only establish their own branches and networks, most notably, foreign giants have taken into their hands those former national champions. In Poland of Eastern Europe, along with the waves of privatization and permission of foreign participation, foreign capital poured into domestic banking industry. Following Citigroup's

acquisition of the Bank Handlowy in 2000, the share of foreign ownership of bank assets in Poland reached about 79% (Gao 2001:2). In Latin America, the takeover fad is more dramatic. So far, about 85% of Mexican banking assets has been controlled by foreigners, the highest such concentration in Latin America (The Banker 2 June 2004). The pace of consolidation in Asia has also picked up. In South Korea, foreign investors already held 30% of the domestic banking sector in 2004 (The Banker 5 April 2004). 'It should soon become pointless to distinguish between foreign and locally-owned banks', says head of Korea First Bank, which is owned by UK-based Standard Chartered Bank (Yonhap News 21 November 2005).

Challenges to China's banks after WTO entry

Like what happened in Eastern Europe, Latin America, and South Korea, foreign banks are coming into China with unprecedented power, advantages and ambitions. The challenges posed by global giants are daunting and severe:

- ***Scale***

The first problem is the simple gap in scale between domestic and global financial institutions, in terms of assets and international networks. Take Citigroup as an example, its total assets reaches over USD1.26 trillion,

which almost equals the combination of assets of the biggest four state banks in China (The Banker 2004). Citigroup alone has annual revenues of USD112 billion, and profits of around USD14 billion, many times greater than the entire group of China's four biggest banks (Nolan 2004a: 57). As business is becoming global, so is the banking. Today, about one third of the world's largest financial institutions operate on a global scale. Citigroup now has branches, subsidiaries or offices in more than 100 countries, with HSBC in 76 countries and Standard Chartered Bank in more than 50 countries. Bank of China, as the most internationally-oriented Chinese bank, only has operations in 27 countries (BOCAR 2004).

The relatively small scale of China's financial services sector means large competitive disadvantage with the global leaders in terms of unit costs, expenditure IT systems, brand building, risk management, product development and diversification, and ability to attract the best staff and to provide services for global clients (Gao 2001).

● *Scope*

In this information age, not only is the financial industry constantly innovating, but also the needs of its customers are growing and diversifying. Foreign conglomerates have integrated commercial banking,

investment banking and insurance business and are increasingly enjoying economies of scope, and engaging top clients around the globe. On the other hand, China's Commercial Bank Law in 1995 separated commercial banking from investment banking and insurance. The policy of segregation is focused on risk prevention rather than international competition and nurturing internationally competitive players. As a result, the narrow business scope is becoming a more and more significant shortcoming for China's banks. Since unable to provide one-stop-shopping services, Chinese banks find it difficult to contract big quality clients. Meanwhile, because Chinese banks are not presently engaged in profitable activities such as investment banking, securities and insurance, the average rate of return in 2004 for banking institutions internationally was 1.2 percent, three times higher than the 0.4 percent in China (Chan 2005).

● ***Innovation capability***

In order to maintain the competitive advantage, big global players make huge investment in IT to create and deliver new products, improve services, and reduce costs. Business is becoming both faster paced and more analytical. IT has been a powerful instrument for developing competitive advantage and expanding market share. It is the easiest, most cost-effective and rapid way to become a global operator. In 1990s, 35

global banks led by Citigroup made IT investment of USD175 billion (Jiao 2001:138). Such huge investment was crucial for innovation and development. The trend is escalating. At present, the annual IT input of Deutsche Bank is USD4.8 billion, for Citigroup, the annual input is as high as USD5 billion (China Computer Daily 21 September 2004).

Through ATM, POS, bank card, internet, satellite and so on, foreign giants not only have changed the operation methods and environment of banks, but also re-engineered and restructured the business flows and management streams. One of the important consequences of rapid IT development is the financial innovations and easier deliverance of products and services. Foreign banks, from the 1980s, have created a wide range of new products (Liu Mingkang 2002:11), including financial futures, options, swaps, bill facilities, e-business, all kinds of derivatives and securitized financial assets. '[T] here will no longer be clear dividing lines between raising money for corporations through commercial paper or through share issues, through long-term or through short-term instruments, depending on regulation and requirement. Instead, debt will become interchangeable, an endless stream flowing one currency to another and from one type of paper to another without difficulty' (Hamilton 1986).

On the other hand, the IT input of China's state banks is quite small, compared with foreign giants. For Bank of China, during 1990s, the annual input was about USD0.24 billion. IT staff accounts for 2.6% of all BOC staff, compared with the average level of 7% in global giants¹.

An industry expert commented, 'The competition of banks focuses on IT strength' (China Computer Daily 21 September 2004). In order to maintain and further sharpen competitive advantage in China, Citibank has applied for 19 patents relating to 'commercial methods'. At least 8 other foreign banks have submitted patent applications to State Intellectual Property Office of China (Xinhuanet 20 January 2003). If their applications are approved, domestic banks have to pay patent fee for some types of businesses, otherwise, they face huge fine. One result of lagging behind in innovation capability is that, Chinese banks are gradually marginalized in the global value chain. That is: they have to cling to their traditional banking products, especially lending business, which bring about 90% of their profits (Chen 2005:34); whereas the high-growth and lucrative products such as syndicate loans, asset management, Internet-banking will be lost to their foreign competitors.

¹ From the author's interview at Headquarters of BOC in 2004.

● *Productivity and quality*

Efficiency Comparison between Domestic v.s. International Banks

USD million, 2002

	Total assets	Net profit	Profit Per capita	ROA	ROE	NPL ratio %
BNP Paribas	710,319	3,295	37,571	0.52	16.74	6.45
Citigroup	1,097,190	15,276	61,104	1.48	20.01	2.34
Bank of America	66,458	9,249	n/a	1.23	16.40	1.47
HSBC	795,246	6,239	33,833	0.90	13.69	2.90
Industrial and Commercial Bank of China	571,768	746	1,841	0.14	3.35	25.69
Bank of China	350,931	1,141	5,927	0.34	4.31	22.50
China Construction Bank	372,367	520	1,694	0.15	4.01	15.17

Source: Xu, 2004, p3

The above table indicates that, not only the scale of assets of Chinese banks much smaller than that of leading global firms, but, crucially, domestic banks have lower asset quality than foreign giants. For example, the Non-performing loan (NPLs) ratio for BNP Paribas, which was 6.45%, highest among the foreign banks on this list, was much lower than 20% for Chinese banks. Chinese banks have a chronic problem with issuing improper loans. This is related not only to state banks' loan management and business operations, but also to excessive government intervention. During recent years, in spite of a series of measures to deal with NPLs, the general NPLs ratio of four state banks in 2005 is still above 10% (CBRC website). Even this number is an understatement, for it excludes inter-bank and trust lending as well as credit that is concealed in balance

sheets as ‘other items’. In most instances, in order to show good performance, some banks intentionally grant new loans to insolvent debtors and get interest back, so that NPLs do not appear on balance sheets.

Besides asset quality, the productivity of China’s banks is also unimpressive. In 2002, the net profit of Citigroup was almost 10 times of BOC, which was the most profitable bank among the big four. If the factor of employees is considered, the profits per capita in China’s banks are negligible when compared with global giants. In 2002, ICBC and CCB’s profits per capita were about USD1,842 and USD1,694 respectively, in sharpest contrast, Citigroup and HSBC had profits per employees of USD61,104 and USD33,833 respectively. Everybody knows that Chinese banks maintain a huge number of employees. Even recently, after corporate restructuring, BOC found out 70,000-80,000 surplus employees. But due to the consideration of social impact, the staff will not be fired, but will receive training or be transferred to other banking posts (Jinghua Daily 15 April 2004). Return on Equity (ROE) and Return on Assets (ROA) on this table also strongly indicate that foreign banks are much more profitable and efficient than Chinese counterparts.

Besides superiority in scale, scope, innovation capability and productivity, foreign banks also possess some other advantages. For example, they have established sound and effective corporate governance, and in particular, are very experienced in strategic planning and risk control. They have more freedom than Chinese banks in their personnel policies, such as recruiting the best talent and professionals from the market, and cutting off surplus employees (Gao 2001). Meanwhile, because of their stringent internal control and monitoring mechanism, foreign giants have far fewer banking crimes than Chinese counterparts, and enjoy higher reputation and public trust. And foreign institutions are able to operate without the Chinese government intervention faced by domestic competitors. All these have intensified their competitive advantages in China's financial market.

Aggressive efforts of foreign banks in China

Wolves are very strong; meanwhile, they are extremely aggressive. Along with the WTO entry, foreign banks have accelerated their pace of development in China, and strengthened their influences day by day. So far, with a small asset share of 1.6% of total banking assets in China, they have already grabbed 40% of international settlement and 23% of foreign currency lending (Liu Mingkang 2004). The annual growth of their assets, deposits and loans all exceeds 30% (CBRC 2005). During this intensified

competition, foreign banks have gradually proved their advantages in providing services in such areas of loan syndications, trade financing, retail banking, asset management, derivative business, and etc. (CBRC 2005). China's top think tank, the Chinese Academy of Social Sciences, warns that WTO accession would result in state banks' losing their best customers to their foreign competitors. The warning came to real. In 2002, the telecommunication joint venture Ericsson in Nanjing dumped ICBC and shifted its business to Citibank, Shanghai Branch (EMKT 2002). The so-called 'Ericsson Incident' shocked China's banking community and became a big issue on newspapers. Soon afterwards, Tianjin Motorola followed suit, and suddenly repaid its loans of RMB1 billion to BOC ahead of schedule, and transferred its accounts to Tianjin Branch of Chase Bank (Huang 2003). In May 2003, a joint venture in Qinhuangdao complained about the coarse and informal statements provided by Chinese banks, and became the client of a foreign competitor who could provide better services (China Business 28 May 2003).

Besides competing ferociously with Chinese banks, foreign capital speed up their stake investments. By the end of 2005, 18 foreign financial institutions participated in 16 Chinese banks, with the total investment reaching USD 12.6 billion (Tang 2005). Royal Bank of Scotland, Merrill Lynch and other investors bought 10 percent of the BOC. Bank of

America spent \$3 billion for 9 percent of the CCB. Only recently, a team of Goldman Sachs, Allianz of Germany and American Express paid USD 3.78 billion for 10% stake with the ICBC, China's largest state-owned bank (Caijing 27 January 2006). Foreign capital also participated in joint-stock banks like BoCOM, Shanghai Pudong Development Bank, Shenzhen Development Bank, and other city commercial banks (Tang 2005). It is estimated that, by 2007, foreign financial groups will control one sixth of China's banking system (Chan 2005), although as of end-October 2005, the asset share of foreign banks in China only accounted for about 2 per cent (CBRC 2005).

It is true that foreign stake investment may bring in advanced management expertise, improved risk controls, and more transparent corporate governance, and promote domestic banking institutions to do better. On the other hand, as strategic partners, foreign banks can benefit from local bank networks, and gain a big foothold in China's market. For example, for the time being, no foreign banks can issue their own credit cards within the mainland China independently due to regulatory restraints. As strategic investors, foreign banks can sidestep this restraint. Citibank issued a dual-currency credit card with the Pudong Development Bank in Shanghai. HSBC also launched a jointly-operated credit card unit with Bank of Communications (China Daily 5 November 2004). More

importantly, by acquiring an existing bank in China, the acquirer gains a more rapid foothold than would be possible with an organic growth strategy. By partnering with the CCB, for example, which has 136 million deposit accounts and 14,500 branches across the country, Bank of America can get access to the huge customer base that it would otherwise take years to build. Consequently, Bank of America will be able to ‘cherry pick’ the best clients and engage in corporate lending as well as consumer banking activities such as mortgages and wealth management (Chan 2005).

A brief comparison with the pre-1949 scenario

The foreign banks’ Challenges in China’s financial market is, in fact, not new in China’s history. After the 1840 Opium War, ‘the western policy towards China had progressed from gunboat policy to financial gunboat policy’ (Wang 1999:4). Western banks came in and grew up in the treaty ports under the protection of extraterritoriality. HSBC, National City Bank of New York (Citibank today), Chartered Bank of India, Australia & China (Standard Chartered Bank today) and etc. became famous names. They financed foreign trade, handled foreign exchange, and issued banknotes. They owned strong financial strength, international networks, modern management and high quality clients. Until 1927, the foreign banks had enjoyed absolute competitive advantages and had dominated

the Chinese financial landscape (ibid).

On the other hand, ‘China was changed by her modern encounter with the west’ (Feuerwerker 1995:181). The existence of western banks produced demonstration effects and motivated the mergence and growth of Chinese modern banks. Although much smaller and weaker, Chinese banks were courageous to challenge foreign rivals (Allen 1954). Through learning from foreign counterparts, seeking government support, establishing modern corporate governance, and adopting innovative approaches and methods, Chinese banks stood on their own, expanded and gained prosperity. They broke the monopoly of foreign banks in foreign trade and international business, established close relationship with big Chinese firms, attracted an increasing share of deposits, and expanded the note issue all over the country (Cheng 2003). During this process, Chinese banks greatly improved their financial strength, expanded networks both home and abroad, and modernized the management. And by the middle of 1930s, Chinese domestic banks finally ‘outweigh foreign banks in overall importance’ (Nolan 1993:46).

Compared with what happened half a century ago, today’s situation is completely different. In the early half of the 20th century, although foreign banks operated in China’s market earlier, had more experience in

modern banking, and owned remarkable competitive advantages, the banking business was relatively simple, focusing on loans, deposits, remittance, foreign trade business. No complicated banking equipment and techniques were involved, no computer was used to design and deliver services. Although Chinese banks were smaller in assets, loan business, and note issues, the gap between domestic and foreign banks was only quantitative, and it was possible for Chinese banks to catch up. However, since 1980s, financial deregulation, along with the development of information technology, has caused great changes through globalization and convergence in the financial service industry (Wu 2001). The boundaries of geography and product sectors are disappearing at high speed. Foreign banks enjoy massive competitive advantages in scale, scope, innovation capability and productivity. Especially, financial innovation has become the indispensable lubricant and driver of global economic development. The strong innovation capability determines the core competitiveness of foreign banks. It is possible for Chinese banks to augment their assets and expand their physical international network; it is also possible to broaden their business scope with the issuance of government's new policy. However, it is extremely difficult for Chinese banks to improve their innovation capability. For many years, Chinese banks, especially state banks, under central planning, mainly deal with SOEs and provide simple and low

value-added products and services, primarily concentrating on interest-based business. Chinese banks lack financial resources, human power, and competitive environment to initiate new products, introduce new methods of production, develop new techniques, and even reorganizing the banking industry. For one thing, the product category of Chinese banks only covers 100~200, whereas the innovative products and services of foreign banks reach more than 10,000 (Liu Xiliang 2004). Chinese banks' much weaker innovation capability indicates that the gap between Chinese and foreign banks is qualitative instead of quantitative. It also suggests that Chinese banks will have to cling to their low-end traditional banking products in the global value chain. It further indicates that Chinese banks have lower quality customers, with less opportunity to earn high margins and generate large profits. Consequently, it will be impossible for China's state banks to compete with foreign giants on the global playing field; also, it is highly unlikely for China's state banks to catch up with the global giants in the foreseeable future.

In 1920s and 1930s, when Chinese banks competed fiercely with foreign competitors, the rise of nationalist sentiment helped Chinese modern banks gain financial power. One consequence of the 1919 May Fourth Movement was that Japanese banknotes were rejected by Chinese people. The 'May Thirtieth Massacre' in 1925 intensified the tempestuous

anti-imperialists movement in China. The business of HSBC and other British banks was heavily impacted. Nowadays, it is hard to foresee that this kind of nationalism will boost China's banks. In addition, First World War, Second World War, and the Great Depression disrupted and affected the development of foreign banks. For instance, the once powerful Deutsch-Asiatische Bank (which established its Head Office in Shanghai in 1890), was closed down during the World War One. Later, although this bank resumed operation, it never regained its previous power and influence (Hong 2004:169-70). True, nowadays, worldwide incidents may happen, such as the terrorist attack or the stock market crash, but with the deepening interdependence of world economy, it is unlikely that one particular bank gets involved without implicating many others. Hence, it is unrealistic to count on unexpected events in advancing Chinese banks.

Conclusion

In the era of globalization, China can no longer be isolated from the outside world. Under the agreement of WTO, restrictions on foreign banks' business scope and geographic expansion by the end of 2006 will be removed. Foreign giants are hungry to penetrate the Chinese market and take the 'cream' of the Chinese financial services market (Nolan 2004b: xix). China's banks, most of which emerged from the old planned economy, will encounter far more serious challenges than it faced half a

century ago.

Still, for the time being, China's big four state banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank, and Agricultural Bank of China) maintain massive physical presence. Their complicated, multi-tier organizational system extends from Beijing to the lowest districts and townships and villages throughout China. The Big Four have long-term commercial and social relationships with their customers (Wu 2001). Many Chinese ordinary people feel foreign banks mysterious and complicated, and still keep the habit of dealing with Chinese banks just around the corner. It will be difficult for multinationals to replace Big Four in the local retail market in the short term. What's more, despite of the unprecedented challenges, WTO entry also brings opportunities to Chinese banks. For example, Chinese banks can fully take advantage of the 'demonstration effect', especially, they can learn from foreign counterparts regarding modern corporate governance, up-to-date banking techniques, and advanced management skills. The good news is that Chinese banks are trying hard to adopt international accounting standards, improve information transparency, establish a well-functioning corporate governance system and get qualified for going public. More and more Chinese banks, like BOC, CCB, Bank of Communications, are recruiting foreign banking experts

(Xingdao Daily 24 October 2005). Even, in the reference of UK's Financial Service Authority, a professional banking supervision agency – CBRC (China Banking Regulatory Commission) has been established. Nevertheless, the complete opening-up of China's banking sector is imminent, and time is not on China's side. A major issue for Chinese policy-makers is the degree to which Chinese banks can survive in the greatly intensified competitive environment.

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