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Cities and Foreign Banking Locations in China

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Cities and Foreign Banking Locations in China

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Abstract

China has gradually reformed its banking sector and relaxed restrictions on foreign banking activities step by step. The gradual approach of reforms and deregulations has indeed guided foreign banks in China. Foreign banks are highly concentrated in Shanghai, Beijing, Shenzhen, Guangzhou, Tianjin and Xiamen. They initially chose special economic zones and the capital city of Beijing, later diffused to Shanghai, Tianjin, Dalian and Guangzhou, and recently to some inland cities. The statistical analysis indicates that banking opportunities, banking sector size and externalities associated with financial centers direct the city choices of foreign banks in China. Foreign banks significantly favor cities with fewer restrictions on foreign banking activities and tend to locate in cities with more international trade and foreign enterprises, suggesting the significance of the follow the customer strategy. The locational choices of foreign banks within China are also dependent on the investing banks' countries of origin. The importance of informational externalities and first-mover advantages would fuel the spatial agglomeration of foreign banks in China.

Key Words: Banking reforms, foreign banks, locational choice, China

Cities and Locations of Foreign Banks in China

1. Introduction

Following the global trend, foreign direct investment (FDI) in China has gradually shifted towards service sectors recently. Under the agreement with the World Trade Organization (WTO), China agreed to allow foreign investments into its services sectors. The Chinese government has honored its commitment and gradually opened the service market to foreign investors since the accession to the WTO. More than 14,700 projects funded by foreign companies in service sectors were approved in 2006 (SSB, 2007). The remarkable growing economy together with the gradual reforms and opening up of the banking sector has motivated multinational banks to establish branches or sub-branches in China (He and Fan, 2004; Okazaki, 2007). By 2007, 193 banks based in 47 countries or regions had established 242 representative offices in China. There were 24 wholly foreign owned banks (with 119 branches) and 2 joint venture banks (with 5 branches) and 3 wholly foreign financial companies. In addition, 71 banks from 23 countries or regions had set up 117 branches in China. Foreign banks possess total assets of RMB1252.5 billion and account for 2.38% of China's total banking asset (CBRC, 2008).

Studies on foreign banking have been flourishing since the 1980s, focusing on international banking in and from developed economies such as the United States, Europe and Japan (Aliber, 1984; Williams, 1997, 2002). The gradual expansion of international banking in China has triggered a series of research on foreign banking activities. The existing studies however target at the expansion of foreign banks in China as a whole or a particular city such as Shanghai. For instance, Leung and his co-authors have published several papers examining factors determining the decision of a foreign bank to establish a branch or a representative office in China or Shanghai, discussing the profitability and the competitive advantages of foreign banks in China, and the managerial implications of China's accession to the WTO for foreign banks (Leung 1997; Leung and Young, 2002; Leung et al., 2003; Leung and Young, 2005; Leung and Chan, 2006). Bonin and Huang (2002) discussed the influence of foreign banks on China's banking sector. He and Fan (2004) briefly reviewed the developments of foreign bank entry in China during 2002-2004. Lu and Dewhurst (2007) explored factors affecting the growth of foreign banks' branches in China. Wu et al. (2007) investigated the effect of foreign banks on the operational performance of domestic commercial banks. Liu and Wu (2008) descriptively compared the provincial distribution of domestic and foreign banks in China. Zhang and Yang (2007) examined the distribution of foreign banks among 16 Chinese cities by 2006 and found the expected significance of international trade and per capita income in determining the locations of foreign banks in China.

The current literature however remains rather insufficient theoretically and empirically regarding the locational choices of foreign banks within China. In particular, no efforts have been made to test how banking reforms and externalities in the banking sector influence the locations of foreign banks. Existing studies have not examined whether the attributes of parent banks have impacts on the locational choices of their branches or sub-branches. This study will apply the eclectic paradigm of international production to shed light on the entry of foreign banks in China. We will simultaneously consider the roles of parent banks' ownership advantages and internalization advantages, and locational advantages of Chinese cities in determining locations of foreign banks in China using a conditional logit model. The statistical results imply that foreign banks significantly favor cities with more banking

opportunities, larger banking sector and fewer restrictions on entry of foreign banks. Cities hosting the headquarters or regional headquarters of the central bank are also the favorable locations. Foreign banks tend to locate in cities with more international trade and foreign enterprises, suggesting they follow the customer strategy. Locational choices of foreign banks are also influenced by the characteristics of parent banks. For instance, larger banks and multinational banks based in Europe and North America are more likely to set up branches or sub-branches in Beijing and Shanghai. Late comers are more likely to locate in the favorable cities such as Beijing, Shanghai, Shenzhen and Tianjin. Multinational banks are also found to use Beijing to serve enterprises from their home countries.

The paper is organized as follows. After the introduction, this study reviews the ongoing implementation of banking reforms and the gradual opening up of the banking sector in China. The fourth session discusses factors influencing international expansion of foreign banks based on Dunning's eclectic paradigm. The fifth part describes the structural and geographical pattern of foreign banks in China, and explains their locational choices applying a conditional logit model. This paper concludes with a summary of key findings and discussions on the future of foreign banks in China.

2. Towards a Market-oriented Banking System: the Gradual Implementation of Reforms in China's Banking Sector

The reforms in China's banking sector have been carried out gradually, with an objective of building a market-oriented banking system (He, 2005; Okazaki, 2007). During the last three decades, China has made remarkable progress in transforming its banking system. Before 1978, the Chinese banking system was a Soviet-style mono-banking system. During the Cultural Revolution, most Chinese financial institutions were closed or incorporated into the People's Bank of China (PBC) or the Ministry of Finance (MOF). The PBC acted as an accountant and cashier for the government rather than a bank. All lending by the PBC was policy-based; the availability, size, term and interest rates on loans were administratively determined (Nanto and Sinha, 2002). The banking system only played a very limited role in promoting economic growth. As part of the economic reform, China has progressively restructured its banking system from one strictly centralized control to a diversified and functionally more specialized system since the late 1970s (He, 2005). By 2007, the Chinese banking system consisted of a central bank and a regulatory body under the supervision of the State Council and a variety of commercial banks (Figure 1).

The banking reforms in China have proceeded in stages. The first stage (1978-1992) was to transform the mono-banking system into a multilayered banking system consisting of a central bank and various kinds of financial institutions (Shang, 2000; Nanto and Sinha, 2002; Okazaki, 2007). The first reform dated back to 1978, when the PBC was transformed from being an arm of the MOF into a stand-alone bank, exercising functions proper to a central bank as well as undertaking commercial banking business. This reform introduced a real distinction between budgetary appropriation and bank financing (Wu, 2005). In 1979, three state-owned specialized banks were reestablished or separated from the PBC, including the Agricultural Bank of China (ABC), the Bank of China (BOC) and the People's Construction Bank of China (PCBC), renamed the China Construction Bank (CCB) in 1996. The Industrial and Commercial Bank of China (ICBC) was set up in 1984 to serve a client base consisting of industrial and commercial enterprises. Since the mid-1980s, the government has loosened the business area restrictions on the specialized commercial banks.

In 1984, the PBC was explicitly designated as a central bank to carry out monetary policy, monitor financial markets, and issue bank notes and no longer allowed to conduct commercial business. However, the PBC was still a part of the State Council and required to manage the funding of the SOEs. In 1986, the Bank of Communications was reestablished with several types of shareholders, later called a Joint-Stock Bank (JSB). By the end of 1992, nine JSBs had been established. In addition to these banks, various other financial institutions were established, including insurance, securities, finance, leasing, trust and investment companies, urban and rural credit cooperatives (Shang, 2000; Okazaki, 2007). Foreign banks were also allowed to establish business entities in China, and there were 98 branches/local subsidiaries and 302 representative offices by 1992.

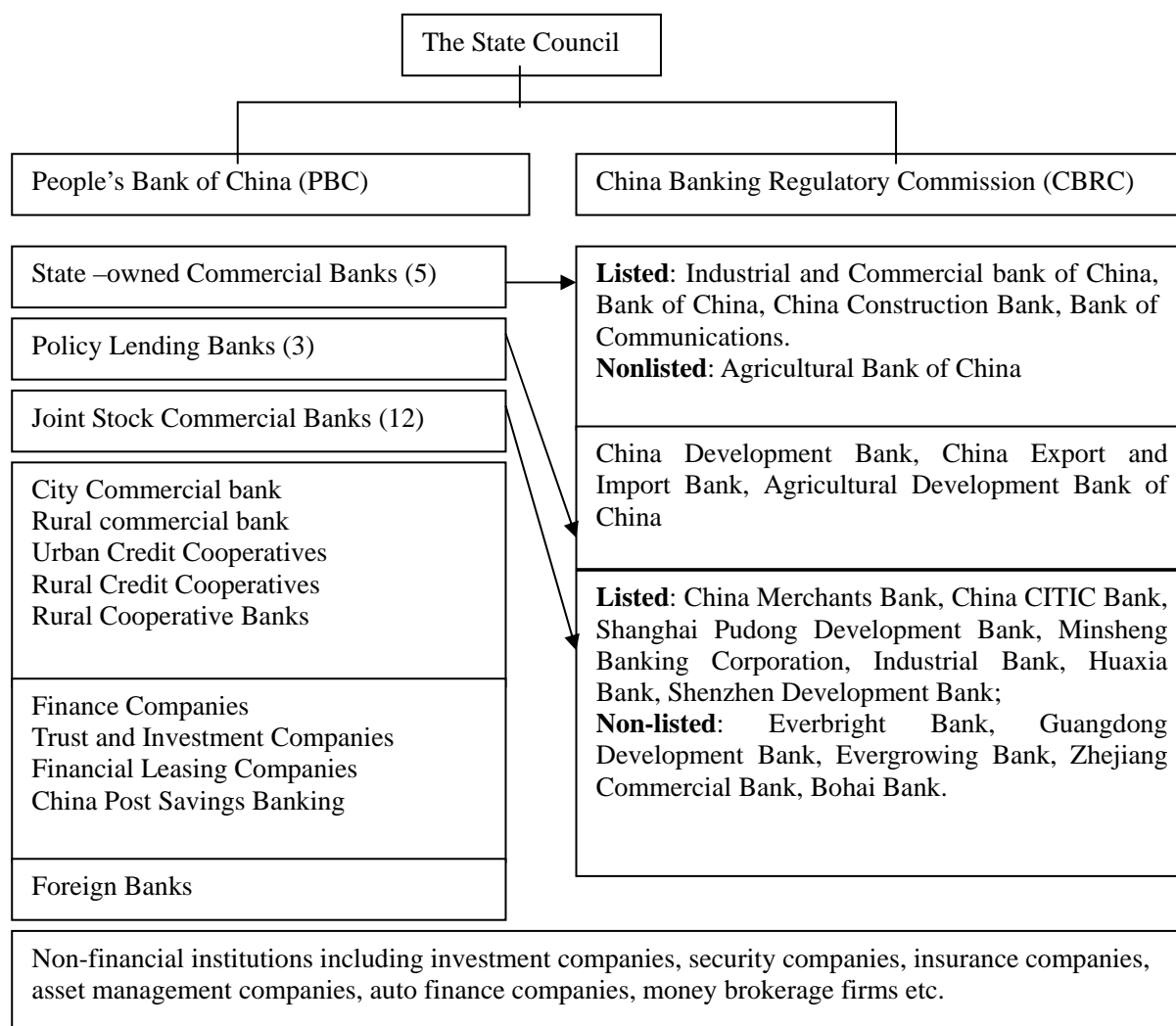


Figure 1 Current Structure of Banking Sector in China (2007)

Sources: PBC, CBRC, China banking Association, Nanto and Sinha (2002); Okazaki (2007)

The second stage (1993-1997) prepared for further market-oriented reforms in the Chinese banking sector. In December 1993, the State Council issued the *Resolution on Financial Reform* and set the targets of the financial system reform as the establishment of an independent economic control mechanism by the PBC, the establishment of policy banks, the transformation of state-owned specialized banks to actual commercial banks, the establishment of unified, open, well-ordered, competitive and well-managed financial markets, the reform of foreign exchange

control, the issuance of appropriate guidance for the development of non-bank financial institutions, and the development of a financial service infrastructure and the establishment of a modern financial management system (Shang, 2000; Wu, 2005; Okazaki, 2007). To implement this policy, the Chinese government established three policy banks in 1994, including the China Development Bank, the Export and Import Bank of China, the Agricultural Development Bank of China. The four specialized banks became known as “state-owned commercial banks (SOCBs)”. A series of reforms have been carried out to strengthen the management of the commercial banks on a consolidated legal person basis, de-link them from their non-banking arms and improve internal management and risk control mechanism (He, 2005; Shang, 2000).

In 1995, the State promulgated a series of laws and regulations in the financial sector. The promulgation of the *Law of the People’s Republic of China on Commercial Banks* was to enhance the independence of the commercial banks. The *Law of the People’s Republic of China on the People’s Bank of China*, the *Insurance Law of the People’s Bank of China*, the *Law of the People’s Republic of China on Negotiable Instruments* and the *Guarantee Law of the People’s Republic of China* provided legal foundations for the rule of laws in the financial sector. The *Law of the People’s Bank of China* legally designated the PBC as the central bank. In 1998, the PBC conducted an organizational and management restructuring and its 32 provincial branches were consolidated into 9 regional branches, strengthening the independence of the central bank in implementing monetary policy as well as financial supervision and regulation. In 1998, the PBC transferred the supervision and regulation of the securities and insurance industries to the newly created China Securities Regulatory Commission (CSRC) and China Insurance Regulatory Commission (CIRC). Other reforms during this stage included the removal of credit plans, reduced government intervention in credit allocation, entry deregulation, a narrowing of the scope of business, interest rate deregulation, tightened accounting and prudential norms and financial sector restructuring (Okazaki, 2007).

The third stage (1997-2002) started some drastic reforms in China’s banking sector. The Asian financial crisis of 1997 reminded China of the importance of the banking sector stability. The Chinese leaders were also seriously worried about the fragility of the financial sector and about insufficient supervisory systems in China (Wu, 2005). In November 1997, the State Council held the *First National Financial Work Conference* and decided to promote the financial system reform intensively, mainly focusing on the rehabilitation of the four SOCBs. Since 1998, the government has moved aggressively to eliminate bad loans from the major SOCBs and consolidate them in asset management.

In August 1998, in order to promote commercial lending by SOCBs, the PBC required SOCBs to improve the assets and liabilities management practices, representing the first step on a path leading to the voluntary management of their fund allocation. The SOCBs gained more rights to independently choose the projects and the enterprises to which they extended loans (He, 2005). To clean up the deteriorated balance sheets of the SOCBs, the government injected RMB 270 billion into the four SOCBs by issuing special treasury bonds, and at the same time spun off RMB1400 billion worth of their Non-Performance Loans (NPLs) in 1998 (Ma, 2006; Leng, 2006). In the same year, the State created four asset management companies (AMCs) to help the dispose of the estimated USD 500 billion in NPLs (Leng, 2006). The four AMCs are China Huarong Asset Management Corp., China Great Wall Asset Management Corp., China Orient Asset Management Corp. and China Cinda Asset Management Corp. In 1999, the Chinese government carved out RMB 1.4 trillion in

NPLs from the four SOCBs at par value and transferred them over to four AMCs. In June 2004, to help both CCB and BOC accelerate preparations for their overseas listings, the PBC and MOF organized another transfer of NPLs at the two banks, valued at RMB 278.7 billion, to Cinda. Meanwhile, the government has taken measures to increase the capital adequacy of the SOCBs. Reforms have expanded the scope of business of those banks, separating policy operations from commercial business and strengthening internal management and risk prevention capacity and improved competitiveness (Leng, 2006).

During the fourth stage (2002-present), China's banking sector has moved rapidly toward a market-oriented banking system. The State held the *Second National Financial Work Conference* in 2002. In 2003, the China Banking Regulation Commission (CBRC) was created to fill the need for the specialized regulation of an increasingly complex banking system. The change allows the PBC to focus on the formulation and implementation of monetary policy, whereas the CBRC on effective bank supervision (Leung and Chan, 2006). The Conference proposed to transform the SOCBs into JSCBs, which will be listed on stock exchanges through initial public offerings (IPOs). To promote this reform, the Central government adopted four key measures to facilitate the restructuring of China's banking sector, including capital injection, granting the banks approval to issue subordinated bonds to supplement their capital, the disposal of NPLs through AMCs, and permitting the introduction of foreign strategic investors (He, 2005; Leng, 2006; Ma, 2006).

To inject capital into the banking sector, the Central government established Central Huijin Investment Company (Huijin) in December 2003 based on the investment of the foreign exchange reserves by State Administration of Foreign Exchange. Huijin injected RMB 500 billion to four SOCBs as a whole since 2003. Huijin was expected to become an influential shareholder of SOCBs. As a part of the preparation for IPOs, BOCOM, CCB, BOC and ICBC were allowed to transfer their NPLs to AMCs, totaling more than RMB 1200 billion, which was about 80% of their reported NPLs and 18% of the loan balance at the end of 2002. In June 2004, the BOCOM, the fifth largest bank in China, was recapitalized to the tune of RMB 35 billion. This recapitalization was a hybrid one financed by funds from the government, public agencies, existing shareholders, as well as domestic and foreign investors (Ma, 2006).

During this stage, the most drastic policy change was to introduce foreign strategic investors in China's banking sector (Ito, 2006; Hope and Hu, 2006; Okazaki, 2007). The CBRC issued a rule regarding foreign equity investment in Chinese financial institutions in 2003 and raised the limit on equity shares held by a foreign investor up to 20%. The foreign strategic investors are expected to bring long term capital, transfer new management systems and techniques, and improve the corporate governance of the commercial banks (Leng, 2006). According to the CBRC, by 2006, about 30 foreign financial institutions had purchased stakes in 21 Chinese commercial banks through strategic investment agreements. Foreign financial institutions originate from a variety of countries or regions, including the United States, Japan, Singapore, Germany, Hong Kong, France, Australia, Netherlands, ADB and IFC (Table 1). For instance, ICBC attracted investments from Goldman Sachs, Amex and Allianz. BOC drew a rather diverse strategic investors, including Royal Bank of Scotland, Merrill Lynch, Li Ka Shing Foundation, Temasek, UBS, ADB, and Mitsubishi UFJ Financial Group. Bank of America became the sole foreign strategic investor of CCB in June 2005 and contributed to 9.1% of total capital. HSBC became the only foreign strategic investor for BOCOM in 2004, with 19.9% of total capital. Foreign participation offers

domestic banks the prospects of better management practices, attractive opportunities for business cooperation, enhancement of their reputations in capital markets, and injections of equity capital (Hope and Hu, 2006; Ma, 2006; Leng, 2006).

Table 1 Foreign Strategic Investors in Chinese Banks by 2006

Chinese banks	Foreign strategic investors	Nationality	Date of agreement	Deal size (\$Million)	Share in capital (%)
State-owned commercial banks					
ICBC	Goldman Sachs/Amex/Allianz	USA/Germany	Jan.2006	3780	10.0
BOC	Royal Bank of Scotland/Merrill Lynch/Li Ka Shing Foundation	UK/USA/Hong Kong	Aug.2005	3048	10.0
	Temasek	Singapore	Sept.2005	1524	5.0
	UBS	Switzerland	Sept.2005	500	1.6
	ADB	International	Oct.2005	75	0.2
	Mitsubishi UFJ Financial Group	Japan	June 2006	180	0.2
CCB	Bank of America	USA	June 2005	2500	9.1
	Temasek	Singapore	July 2005	1466	5.1
Joint-stock commercial banks					
BOCOM	HSBC	UK	Aug. 2004	1747	19.9
Shanghai Pudong Development Bank	Citigroup	USA	Sept.2003	72	4.6
Mingsheng Bank	Temasek	Singapore	Nov. 2004	106	4.6
	International Finance Corp	International	May 2003	24	1.2
Everbright Bank	ADB	International	Jan. 1997	20	3.0
Industrial Bank	Hang Seng Bank	Hong Kong	Dec. 2003	208	16.0
	GIC	Singapore	Dec. 2003	50	5.0
	International Finance Corp	International	Dec. 2003	70	4.0
Huaxia Bank	Deutsche Bank	Germany	Oct. 2005	325	14.0
	Pangaea Capital Management	Singapore	Oct. 2005	125	6.9
Guangdong Development Bank	Citigroups	USA	Nov. 2006	723	20.0
Shenzhen Development Bank	Newbridge Capital	USA	June 2004	149	17.9
	GE Consumer Finance	USA	Oct. 2005	100	7.0
Bohai Bank	Standard Chartered Bank	UK	Sept. 2005	123	19.9
City commercial banks					
Bank of Shanghai	IFC	International	Sept. 1999	50	7.0
	Shanghai Commercial Bank	Hong Kong	Dec. 2001	20	3.0
	HSBC	UK	Dec. 2001	63	8.0
Bank of Beijing	ING Group NV	Netherlands	Mar. 2005	215	19.9
	IFC	International	Mar. 2005	50	5.0
Tianjin CCB	ANZ Banking Group	Australia	Dec. 2005	120	19.9
Nanjing CCB	IFC	International	Nov. 2001	27	5.0
	BNP Paribas	France	Jan. 2006	87	19.2
Xi'an CCB	Bank of Nova	Canada	Sept. 2002	7	5.0
	IFC	International	Sept. 2002	20	12.5
Ji'nan CCB	Commonwealth Bank of Australia	Australia	Nov. 2004	17	11.0
Hangzhou CCB	Commonwealth Bank of Australia	Australia	Apr. 2005	76	19.9
Nanchong CCB	German Investment & Development Bank	Germany	July 2005	5	13.3
Ningbo CCB	OCBC	Singapore	Jan. 2006	71	12.2
United Rural Cooperative Banks of Hangzhou	Rabobank Group	Netherlands	July 2006	20	10.0
	IFC	International	July 2006	10	5.0

Sources: Hope and Hu (2006), Ito (2006), Okazaki (2007)

After a series of measures to bolster the capital base of the SOCBs through recapitalization, NPL transfer and introduction of foreign strategic investors, Chinese banks are ready for the public listing of bank securities (Leng, 2006). From June 2005 to May 2007, BOCOM, CCB, BOC and ICBC undertook successful IPOs and were listed on Hong Kong or Shanghai stock exchanges. BOCOM and CCB were first listed in Hong Kong stock market. The BOC and ICBC were listed in the Hong Kong and Shanghai stock markets (Okazaki, 2007). In May 2007, BOCOM was also listed in Shanghai stock market. The IPOs have resulted in a drastic change in the ownership structure of Chinese commercial banks, though the state ownership is still dominant (Figure 2).

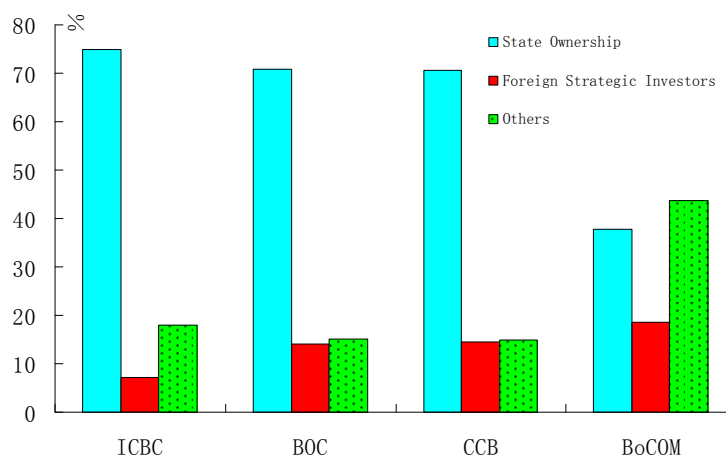


Figure 2 Capital Structure of Chinese Listed SOCBs (2006)

Note: "Others" includes institutional investors, corporate investors and individual investors. Data Sources: Okazaki (2007)

With the successful restructuring and reforms of SOCBs, China's banking sector has been improved significantly. Chinese banks however are far behind most advanced international banks in terms of the quality of assets and profitability (Leng, 2006; Okazaki, 2007). China's financial system is still far being able to accomplish its central task: allocating credit in an efficient way to all sectors. The large amount of remaining NPLs would question the stability of Chinese commercial banks. Commercial banks suffer inefficiency of fund allocations and poor corporate governance. More deregulations of financial markets are also desired. Fraud and corruption are impediments to the further development of banking sector (Leng, 2006). Fortunately, China has deemed to transform its banking system into a market-oriented system. The Chinese government held the *Third National Financial Work Conference* in January 2007 to review the achievements of financial reforms and to discuss reform targets for the next few years. Premier Wen Jiabao emphasized six areas that required intensive efforts: deepening the reform of SOCBs, facilitating rural financial reforms, developing the capital and insurance markets, improving the ability of financial services and functions to adapt to economic development, opening financial business actively and modestly to foreign entities, and strengthening supervision of financial institutions. More profound banking reforms are on the road in the coming years.

2. Gradual Deregulations on FDI in China's Banking Sector

The tale of foreign bank operations in China is also a story of stages (CBRC, 2007). The Chinese government has gradually relaxed restrictions on foreign banks. Following the commencement of economic reform in 1978, foreign banks were allowed to set up representative offices that provided advisory services for foreign

firms in China (Lu and Dewhurst, 2007). Under the WTO agreement, restrictions on the operations of foreign banks have further been relaxed in stages. By the end of 2006, foreign banks gained full access to the Chinese market with the elimination of all restrictions on their business activities (Okazaki, 2007).

According to CBRC (2007), Chinese banking sector has gone through three stages in its opening up process. The first stage (1980-1993) started from the establishment of the representative office of the Japan Import and Export bank in Beijing in 1980. The Nanyang Commercial Bank set up a branch in Shenzhen in the following year, becoming the first foreign-funded bank conducting business in China since 1949. In 1983, China promulgated the *Regulations for Establishment of Representative Offices in China by Oversea Chinese and Foreign Financial Institutions in China*, mainly targeting at banks based in Hong Kong and Overseas Chinese. In 1985, the State issued the *Regulations on the Administration of Foreign-Funded Banks and Chinese-Foreign Joint Venture Banks in Special Economic Zones (SEZs)*, allowing foreign banks to establish branches and conduct foreign currency business in Shenzhen, Zhuhai, Shantou, Xiamen and Hainan. Meanwhile, the Chinese government gradually lifted the geographical restrictions on foreign banks by allowing their presence in the coastal cities beyond SEZs. In 1990, the government promulgated the *Measures for the Administration of Foreign Financial Institutions and Chinese-Foreign Joint Venture Financial Institutions in Shanghai* and officially opened Shanghai to foreign banks. In 1991, the State issued the *Measures for Administration on Representative Offices by Foreign Financial Institutions in China*, further deregulating the FDI regimes in China's banking sector. In 1992, seven cities including Dalian, Tianjin, Qingdao, Nanjing, Ningbo, Fuzhou and Guangzhou were opened to foreign banks to conduct foreign currency business. By 1993, there were 76 foreign banks in 13 cities, with a combined assets amounting to US \$8.9 billion and their business scope covering foreign exchange services to both foreign business corporations and foreign residents (CBRC, 2007). Overall, the Chinese government set fairly strict regulations on the operations of foreign branches in China, limiting their business into foreign currency and foreign firms. Most foreign banks were from Hong Kong, with a few from the United States and Japan.

The second stage started from 1993 and ended in 2001. In 1994, the government promulgated the *Regulations of the People's Republic of China on the Administration of Foreign-Funded Financial Institutions*, which was largely based on the amendments to the 1985 Regulations. The new regulations provided the legislative guidance for the market entry and supervision of foreign banks. The government further relaxed the geographical restrictions on foreign banks and expanded the geographical areas allowing for foreign banks from the coastal and major cities to the nationwide. In December 1996, the government issued the *Provisional Regulations on Foreign Financial Institutions RMB Business on a Trial Basis in Shanghai Pudong Area*, granting foreign banks' access to RMB business for foreign enterprises and overseas residents. Until then foreign banks had mainly met the financing needs of their home customers whom they had followed into China. Foreign banks had effectively operated in a segmented market prior to the liberalizations brought about by China's accession to the WTO (Leung and Chan, 2006). The year 1996 saw the promulgation of a series of regulations on foreign banks, including the *Provisional Measures for the Establishment of Branches in China by Foreign Banks*, the *Provisional Measures for the Administration of Sino-Foreign Joint Venture Investment Banks*, the *Provisional Measures for the Post-holding Qualifications of Senior Managers of Financial Institutions*. Those measures and regulations were set to

manage and supervise foreign bank operations in China and a boost to the development of foreign banks in China then followed. By 1997, there had 175 foreign banks in China, an increase of 99 branches and the total foreign assets in China's banking sector tripled during the period of 1994-1997 (CBRC, 2007).

The Asian financial crisis in 1997 slowed down the entry of foreign banks in China. During 1998-2001, only 15 new foreign banking institutions were established in China (CBRC, 2007). To encourage the entry of foreign banks, the government selected Shenzhen as the second pilot city to allow foreign banks to conduct RMB business. In March 1998, *the Circular of Issues Concerning the Approval to Foreign Banks to Engage in the Inter-bank Borrowing in China* was issued, allowing foreign banks to join the inter-bank market to tap RMB funds. In July 1999, the *Circular about Expanding Foreign Banks' RMB Business Scope in Shanghai and Shenzhen* was issued, relaxing the geographical and volume restrictions of RMB business for foreign banks. Shanghai-based foreign banks were allowed to conduct RMB business in its neighboring provinces of Jiangsu and Zhejiang. Shenzhen based foreign banks were allowed to expand their RMB business to Guangdong, Guangxi and Hunan provinces.

The post-WTO period (2002-) is the third stage of foreign bank operations in China. In its WTO accession agreement, China has committed to a phased-in liberalization of foreign bank access to its banking market (WTO, 2001). Foreign banks were guaranteed full access to the Chinese market with the elimination of all restrictions on their business activities within five years (Nanto and Sinha, 2002; Bahattasali, 2004). Upon the accession to WTO, the geographical and customer restrictions on foreign currency business of foreign banks were removed. Foreign banks in Shanghai, Shenzhen, Tianjin and Dalian were allowed to conduct RMB business, which was expanded to foreign banks located in Guangzhou, Zhuhai, Qingdao, Nanjing and Wuhan in December 2002 and to those in Jinan, Fuzhou, Chengdu and Chongqing in 2003. Meanwhile, foreign banks were permitted to undertake corporate RMB business in cities where RMB business was opened to foreign competition. In 2004, five more cities, including Kunming, Beijing, Xiamen, Shenyang and Xi'an, allowed foreign banks to conduct RMB business, which was further expanded to Shantou, Ningbo, Harbin, Changchun, Lanzhou, Yinchuan and Nanning in 2005 (Figure 3). By December 2006, foreign banks had been permitted to engage in a similar range of financial services as Chinese banks and would be treated and regulated in the same way as domestic banks. All non-prudential market access constraints on foreign banks which restrict ownership, operation and juridical forms of foreign financial institutions, including those on internal branching and licenses, were also lifted (Okazaki, 2007). With the dramatic deregulations on foreign investment in China's banking sector and the gradual removal of geographical and customer restrictions, the number of foreign banks in China expanded quickly from 190 to 312 despite several merger cases during the five years. In particular, the year 2006 saw a large number of new entrants of foreign banks in China.

Following the accession to the WTO in 2001, China has also amended or issued a series of laws and regulations regarding foreign financial institutions to honor its commitments during the five-year grace period allowed under the WTO accession agreement (CBRC, 2007). In December 2001, the government promulgated the *Regulations of the PRC on the Administration of Foreign Funded Financial Institutions*. Its implementing rules were promulgated in January 2002. In December 2003, the State issued the *Administrative Rules Governing the Equity Investment in Chinese Financial Institutions by Overseas Financial Institutions*, setting forth the qualification requirements on the overseas investors with respect to their asset size,

capital adequacy and profit earning capacity as well as the upper limits on such equity investment. In November 2006, the Chinese government promulgated *the Regulations on the Administration of Foreign Banks and its Implementing Rules*. The regulations grant foreign banks easier access to Chinese banking market. Foreign banks are permitted to receive deposits from the general public, grant loans, and handle acceptance and discounting of negotiable instruments. They are allowed to buy and sell government bonds, financial bonds, foreign currency securities and foreign exchange, and provide letter of credit services and guaranty, handle domestic and foreign settlement. Foreign banks may act as an agent for insurance companies and for the purchase and sale of foreign exchange, and engage in inter-bank lending and bank card business, and provide safe deposit box services and credit information services and consultancy services. However, building a larger presence could take some time as foreign banks must satisfy certain requirements before they can be granted approval for offering full domestic currency services to Chinese individuals (Leung and Chan, 2006). For instance, foreign banks must establish an incorporated affiliate in China with minimum capital of RMB 1 billion and each branch must have a minimum capital of RMB 100 million. Furthermore, foreign financial institutions applying to engage in local currency business must have three years of business operation experience in China and have been profitable for two consecutive years. Starting from 2007, foreign banks operations in China entered a new stage in which all geographical and customer restrictions on foreign banks are lifted.

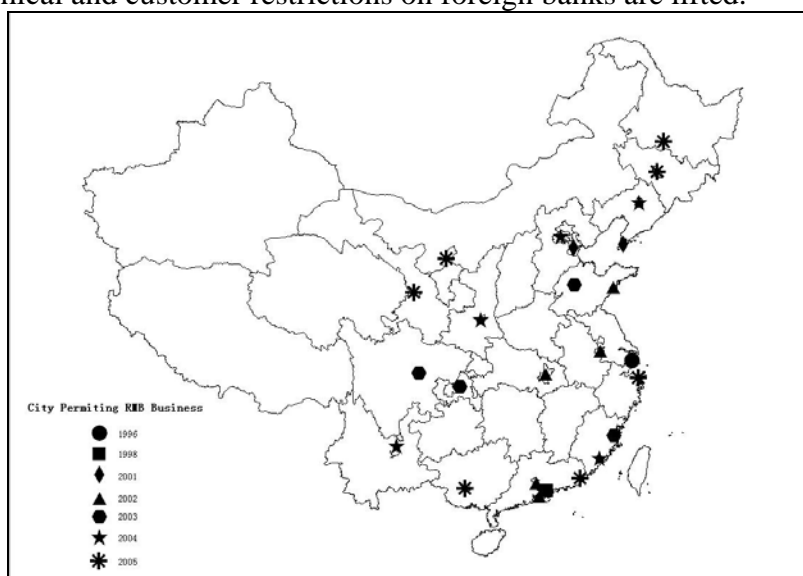


Figure 3 Cities Allowing Foreign Banks to Conduct RMB Business in Different Years
Data Sources: CBRC (2007)

3. Foreign Banks in China: A Theoretical and Empirical Perspective

China has adopted a gradualist approach to lift the geographical and customer restrictions on foreign banking (CBRC, 2007). By 2006, market forces become the main driving forces of foreign banks in China. The question of why foreign banks set up branches or sub-branches in China and where they are located deserve thorough empirical investigations. Dunning's eclectic paradigm has been applied to understand the international expansion of multinational banks (Gray and Gray, 1981; Yannopoulos, 1983; Cho, 1985; William, 1997). The eclectic paradigm approach views FDI decision to be a combination of ownership, internalization and locational advantages (Dunning, 1981). Petrou (2007) indeed found that multinational banks (MNB) are motivated to exploit ownership and internalization advantages when

expanding internationally. This study applies the eclectic paradigm of international banking to shed light on the entry of foreign banks in China.

Ownership Advantages

A multinational bank serving foreign markets via FDI must possess unique ownership advantages that allow it to successfully compete with indigenous banks (Yannopoulos, 1983; William, 1997). Ownership advantages may arise from the foreign bank's ability to differentiate its banking products, the availability of financial and human resources, the possession of superior and unique banking techniques, extensive banking experience, skilled personnel, organizational skills, and a large domestic capital and deposit base (Aliber, 1984; Yannopoulos, 1983; William, 1997). The size and the relevant endowment of resources, the international experience, knowledge and information about foreign markets have been found significant in explaining bank's international expansion in countries like U.S., South Korea, Japan, Italy and Australia (Ball and Tschoegl, 1982; Ursachi and Vertinsky, 1992; Engwall and Wallenstal, 1998; Engwall et al., 2001; Mutinelli and Piscitello, 2001; Moshirian, 2001). In a transitional economy like China, foreign banks would encounter an unfamiliar and uncertain business environment and also suffer serious information asymmetry (Leng and Chan, 2006). Possession of ownership advantages would help foreign banks to overcome the disadvantages of being an alien. Lu and Dewhurst (2007) indeed found that foreign banks' size, multinational operation experience and operating time in the Chinese market are positively related to their possibility of entering China. We anticipate that foreign banks conducting operational business in China possess significant ownership advantages which allow them to compete with domestic banks successfully.

Internalization Advantages

Multinational banks provide cross-border transaction services via FDI because of internalization advantages, which are largely sourced from the role of information in banking (William, 2002). Ownership of the information flows embodied in the bank-client relationship is the main asset of a bank (Yannopoulos, 1983). Information capital embodied is difficult to obtain at arms length due to the failure in the information market and provides opportunities for multinational banks to internalize firm-specific advantages (William, 1997; Miller and Parkhe, 1998). As a result, the bank cannot elect to service its existing clients overseas by exporting information to banks in the host country. Preserving established accounts by opening foreign offices or branches becomes a means for protecting knowledge and information networks (William, 2002). Meanwhile, firms also face imperfect capital markets in the host country and maintaining previously forged bank-firm lending ties allows these firms to acquire the necessary capital to establish their foreign affiliates (Klein et al., 2002; Von der Ruhr and Ryan, 2005).

The argument of internalization advantages assumes the "follow the customer strategy" in the international expansion of banks (Williams, 1997, 2002). By pursuing the follow the customer strategy, the bank can maintain the ownership advantages established in the domestic market as the customer expands into a foreign market. Ursacki and Vertinsky (1992) find that banks must locate nearby to keep accurate information on overseas borrowers as well as to avoid asymmetric information problems. The follow the customer hypothesis has been widely tested and supported. Some studies found that foreign banks follow foreign investors (William, 2002). Nigh et al. (1986), Goldberg and Johnson (1990) and Miller and Parkhe (1998) reported a positive correlation between US banks' foreign activities and manufacturing activities set abroad by US firms in the periods 1976-1982, 1972-1995 and 1987-1995,

respectively. Goldberg and Sanders (1981), Hultman and McGee (1989) and Goldberger and Grosse (1994) confirmed the same result with reference to foreign participation in the US market in the period 1973-1986. Esperanca and Gulamhussen (2001) found that foreign banks in the US follow both their corporate customers and non-corporate customers. Yamori (1998) and Von der Ruhr and Ryan (2005) corroborated the evidence by studying the international expansion of Japanese foreign banks. Banks from European countries such as Germany and Norway are found to follow FDI from home countries (Buch, 2000; Boldt-Christmas et al., 2001). Foreign banks are also found to follow the international traders (Golder and Saunders, 1980; Goldberg and Johnson, 1990; Grosse and Goldberg, 1991; Yamori, 1998; Buch, 2000; Magri et al., 2005). Heinkel and Levi (1992) and Ter Wengel (1995) found that serving home country exporters is a determinant of foreign banking expansion. Brealey and Kaplanis (1996), using a cross-sectoral analysis of the pattern of foreign bank offices across 37 parents and 82 host countries, found a significant relationship between the pattern of bank location, trade and foreign direct investment. Foreign banks also follow traders to choose locations within a host country. The total values of imports and exports in a US state are closely related to the level of foreign banking activities in that state (Goldberg et al., 1989, Golder and Grosse, 1994; Bagchi-Sen, 1995). There is also evidence indicating that foreign banks do not follow their customers. For instance, Seth et al. (1998) found that during the 1980s, Japanese, Canadian, Dutch and British banks in the US allocated a majority of their loans to non-home country borrowers. In a study of U.S. banks in 32 countries during 1987-1995, Miller and Parkhe (1998) found that greater FDI flows to a host country are not associated with foreign bank entry in developing economies. Haselmann (2006) reported that foreign banks do not pursue a follow the customer strategy in the CEE economies, but compete with domestic banks in the same market segments.

China has been successfully merged into the global economy since the late 1970s and has been the largest developing host for foreign investment since the early 1990s (He, 2006). Recently, China has been the top international traders only second to the United States and Japan. Multinational banks may follow their customers to China and to Chinese cities. For instance, Leung (1997) found that the growth in the total number of branches and representative offices during 1980-1993 is positively related to the level of China's external trade and reported that nearly 92% of foreign banks engaged in trade finance and provided loans to Sino-foreign joint ventures, suggesting they follow the customer strategy. Zhang and Yang (2007) reported that foreign banks in Chinese cities are positively associated with international trade, but not with foreign investment. Lu and Dewhurst (2007) however failed to find a significant positive relationship between bilateral investment and trade, and the likelihood of the bank receiving permission to establish branches. Whether foreign banks carry the follow the customer strategy in China, especially in the post-WTO period, remains unclear and deserves further investigations.

Locational Advantages

Locational advantages in host economies are regarded as another necessary condition for international expansion of banks (Yannopoulos, 1983; Cho, 1985). Studies stress the roles of local market opportunities, banking profit opportunities, relaxations of regulations, favorable policies, cultural and geographical proximity (Aliber, 1984; Cho, 1985; Goldberg and Saunders, 1980; Yamori, 1998). For instance, Sabi (1988) found that market size, the extent of economic development and the balance of payments are significant determinants of the growth of multinational banking in LDCs. Goldberg and Johnson (1990) found that the U.S. banks favored

countries with higher per capita GDP. Hultman and McGee (1989, 1990) and Grosse and Goldberg (1991) showed that the size of the banking sector in the foreign country is positively correlated with that country's bank presence in the US. Focarelli and Pozzolo (2001) found that OECD countries with more market opportunities and banking profit opportunity attract more foreign banks. Weller and Scher (2001) confirmed the significance of market size, real economic growth, profit opportunities, the level of development of domestic banking markets and the regulatory environment. Magri et al. (2005) reported that the profit opportunities of the local market in Italy proved to be of great importance. Characteristics of local banking market in terms of size, development and efficiency are found to be positively related to foreign banks (Sabi, 1988; Buch, 2000; Buch and Lapp, 1998; Miller and Parkhe, 1998).

Foreign banks favor locations with fewer restrictions on entry of banking activities (Nigh et al., 1986; Focarelli and Pozzolo, 2001; Clarke et al., 2003; Herrero and Peria, 2007; Dopico and Wilcox, 2002). Nigh et al. (1986) reported that the openness of the host country to foreign banking does affect U.S. foreign banking involvement in that country, especially in less developed countries. Dopico and Wilcox (2002) found that foreign banks tended to have significantly larger presence in countries more open to foreign ownership of banks. Foreign banking was correlated positively with the range of financial activities that banks were allowed to conduct. Herrero and Peria (2007), using data on Italian, Spanish and US banks' foreign claims, found that the share of local claims is driven by restrictions on banking sector openness and by local scale economies/business opportunities. Limits on property rights, entry requirements, start-up and informational costs are also significant but less robust. Goldberg and Grosse (1994) found that foreign banks had a greater presence in states with less strict regulations on foreign activities within the United States.

Cultural and geographical proximity is another significant locational advantage for the international expansion of banks. Larger cultural distance is proved entry barrier in international banking (Grosse and Golderberg, 1991; Esperanca and Gulmussen, 2001). Magri et al. (2005) found that banks from countries at a greater distance were less likely to choose Italy as a location for branches. Bush (2005) reported that banks hold significantly lower assets in distant markets. In addition, the presence of international financial centers in a host country attracts foreign banks due to a variety of positive externalities (Brealey and Kaplanis, 1996; Buch, 2000; Buch and Lapp, 1998; Mutinelli and Piscitello, 2001).

Locational advantages are critical to understand the geographical distribution of foreign banks in China (Zhang and Yang, 2007). Leung et al. (2003) found that Asian banks have particular cultural and locational advantages and are more likely to enter China. Foreign banks have been attracted by the growing business opportunities and improved political environment in China. Leung and Young (2005) found that region of origin, parent bank size, the number of international branches and their branch network in China have a significant impact on the time to entry of foreign banks. A country's share of total FDI in Shanghai also significantly affects the entry decision. Zhang and Yang (2007) found the positive significance of per capita income in attracting foreign banks in Chinese cities. China has gradually opened its cities to foreign banks and lifted restrictions on foreign investment in its banking sector step by step. The gradual approach to China's banking reforms has certainly created locational advantages for the early opened cities, which would attract more foreign banks. The post-WTO period witnessed a large inflow of foreign banks and why they favor some particular Chinese cities remain rather under-explored. This study anticipates that foreign banks intend to exploit ownership and internalization

advantages and locational advantages in China.

4. Understanding Foreign Banking Activities in China

China allowed foreign investment in its financial sector right after the opening-door policy. By the end of 2007, China's financial sector accumulatively realized foreign investment of US dollars 82.32 billion (CBRC, 2008). Foreign financial institutions include representative office, branch, sub-branch, headoffice, finance company and affiliated company. Figure 4 reports new entries and the total numbers of foreign financial institutions during 1980-2006. By 2006, foreign banks established 241 representative offices, 208 branches, 90 sub-branches, 11 head-offices, 3 finance companies and 1 affiliated company in China. The total number of foreign financial institutions has experienced exponent growth since the early 1990s, consistent with the growth pattern of overall foreign investment and the progress of opening-door policies. The 1997 Asian financial crisis significantly slowed down the entry of foreign banks. The accession to the WTO in 2001 further opened China's banking sector to foreign investors, gradually relaxing the geographical and customer restrictions, stimulating another drive of foreign banking operations in China.

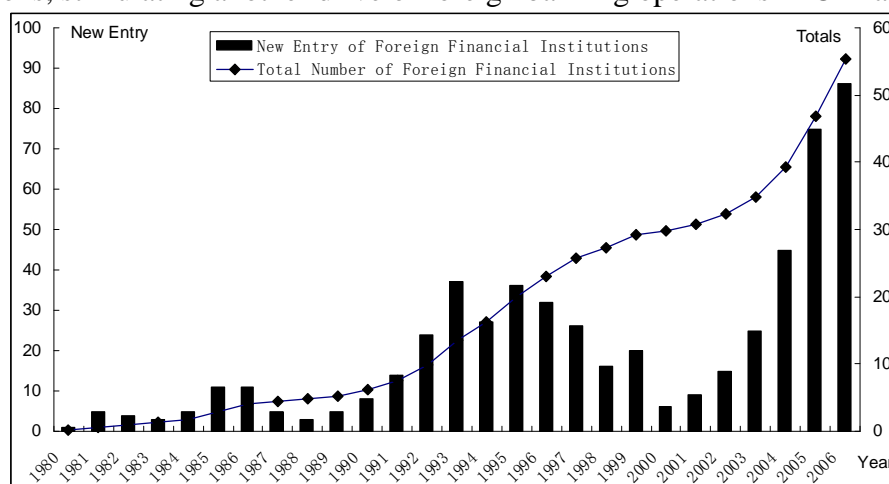


Figure 4 Foreign Financial Institutions in China during 1980-2006
Data Sources: China Society for Finance & Banking (2007)

Figure 5 shows the entry of representative office, branch and sub-branch established by foreign banks in China. Foreign banks set up representative offices in a host country to collect information and hunt for investment opportunities. In the 1980s, foreign banks faced stricter geographical and customer restrictions and chose to establish representative offices in China. As a matter of fact, the State officially allowed the establishment of operational business entities by foreign banks only in special economic zones, including Shenzhen, Zhuhai, Xiamen, Shantou and Hainan. With the relaxation of regulations on FDI in banking sector in the 1990s, more foreign banks established representative offices and some created branches in China. The post-WTO period witnessed a rapid growth of branches and sub-branches. In 2005 and 2006, foreign banks established 21 and 42 sub-branches, respectively. Many more representative offices and branches have been set up since 2002. The gradual lift of geographical and business restrictions during the post-WTO period has created favorable environment for foreign banking operations in China.

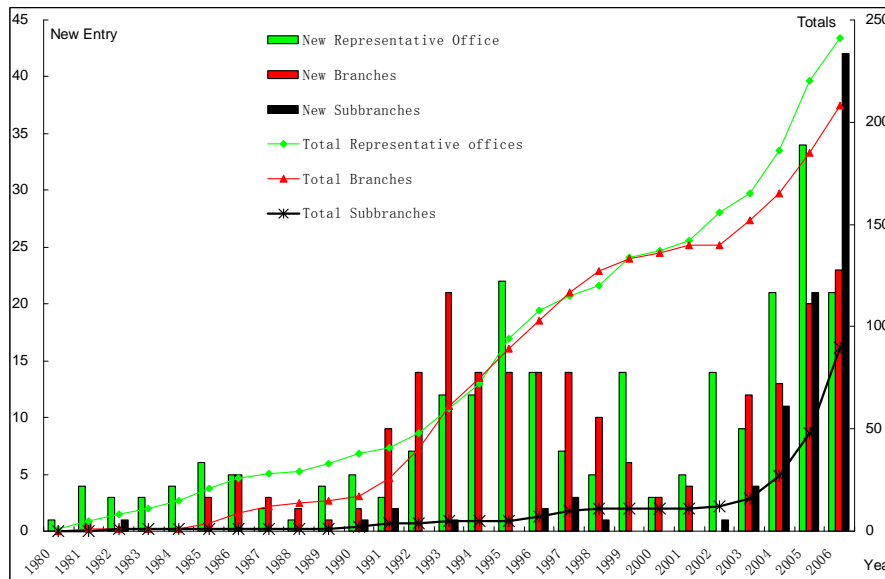


Figure 5 Representative Offices, Branches and Sub-branches Established by Foreign Banks in China during 1980-2006
 Data Sources: China Society for Finance & Banking (2007)

Foreign banks in China originate from 47 countries or regions. Hong Kong and Japan top the list (Figure 6). There are 122 financial institutions from Hong Kong and 71 from Japan. South Korea and Singapore are also critical investors in China's banking sector. The cultural and geographical proximity may have facilitated the entry of oversea Chinese banks and those owned by Asian countries. Foreign banks from Hong Kong, Singapore, Japan and South Korea may follow their customers to invest in China. There are strong bilateral trade and investment flows between Asian economies and China. For instance, many Japanese branches or sub-branches were established by Keiretsu, such as Mitsubishi, Mizuho, and Sumitomo Mitsui, which typically own hundreds of enterprises in China. Meanwhile, some financial institutions are from developed economies in North America and Western Europe such as the United States, Canada, the United Kingdom, Germany, France, Netherlands, Switzerland, Sweden, Belgium and Russia. Those dominant economies have established strong trade or investment linkages with China during the period of economic transition. They are also culturally and geographically remote from China and their enterprises are likely to keep the original bank-client relationship to save transaction costs and switching costs. The massive inflows of foreign investment and rapid expansion of international trade in China speak for the exponent growth of foreign banking operation since foreign banks may follow their customers to China (Leung, 2003).

Table 2 lists the foreign banks with 5 or more financial institutions in China by 2006. Among the 18 banks, 6 banks are based in Hong Kong, 3 in Japan and France, and 2 in Singapore. The Hong Kong and Shanghai Banking Corporation ranks the first, with 14 branches and 19 sub-branches and 1 representative office in the Mainland China currently. The Bank of East Asia, also based in Hong Kong, has set up 31 institutions, including 12 branches and 14 sub-branches. Citigroup from the United States, Standard Chartered based in United Kingdom and ABN AMRO Bank from Netherlands have also built strong presence in the Chinese market. Other important investors based in Hong Kong include Hang Seng Bank Limited, Nanyang Commercial Bank, Bank of China (Hong Kong), Wing Hang Bank. Those based in

Japan include Mitsubishi UFJ Financial Group, Mizuho Financial Group, and Sumitomo Mitsui Financial Group. The United Overseas Bank and Overseas Chinese Banking Corp from Singapore each have 8 business entities in China. French banks such as BNP Paribas, Credit Agricole Group and Societe Generale are also active investors in China. Many investing foreign banks hold critical ownership advantages which may help them to mitigate business risks and compete successfully with domestic banks in China. The large size grants foreign banks advantages in management, capability and knowledge. Ten of the 18 banks rank the top 15 among the largest 1000 banks in the world in terms of total assets. BNP Paribas and Citigroup position the third and the fourth, with total assets of US dollars 1896.94 billion and 1882.56 billion, respectively. The Hong Kong and Shanghai Banking Corporation is the fifth largest bank, with total asset of US dollars 1860.76 billion. The investing foreign banks have also accumulated much country-specific knowledge and experience in China. By 2006, all investing foreign banks had long presence in China, which help them to penetrate the Chinese market. For example, by 2006, The Hong Kong and Shanghai Banking Corporation had been in China for 21 years. Bank of East Asia and Citigroup established their presence in China in the late 1980s. Nanyang Commercial Bank entered China 26 years ago.

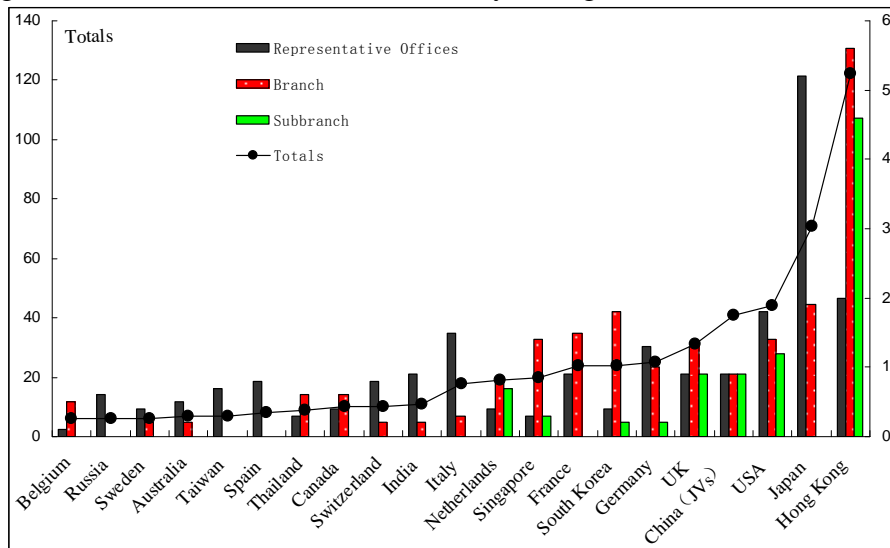


Figure 6 Countries or Regions with 5 or More Financial Institutions in China by 2006
Data Sources: China Society for Finance & Banking (2007)

Table 2 Multinational Banks with 5 or more institutions in China by 2006

Parent Bank	Home	Total	Representative Office	Branch	Sub-Branch	Asset Rank	Years
Hong Kong and Shanghai Banking Corp.	Hong Kong	34	1	14	19	5	21
Bank of East Asia	Hong Kong	31	5	12	14	229	20
Citigroup	US	24	4	8	12	4	19
Standard Chartered	UK	23	4	10	9	60	22
ABN AMRO Bank	Netherlands	15	2	6	7	12	14
Hang Seng Bank Limited	Hong Kong	15	1	7	7	5	22
Mitsubishi UFJ Financial Group	Japan	11	5	6	0	8	24
Mizuho Financial Group	Japan	10	5	5	0	14	23
United Overseas Bank	Singapore	8	0	7	1	135	22
Oversea-Chinese Banking Corp.	Singapore	8	3	4	1	146	16
Sumitomo Mitsui Financial Group	Japan	9	4	5	0	22	22
BNP Paribas	France	7	2	4	0	3	15
Credit Agricole Group	France	6	1	5	0	6	22
Nanyang Commercial Bank	Hong Kong	6	0	5	1	30	26
Bank of China (Hong Kong)	Hong Kong	6	0	4	2	30	22
Deutsche Bank	Germany	5	0	3	2	9	13
Societe Generale	France	5	0	5	0	13	15
Wing Hang Bank	Hong Kong	5	1	3	1	468	14

Note: “Years” indicates the number of years between 2006 and the year when a foreign bank established its first business entity in China.

Data Sources: China Society for Finance & Banking (2007); The Banker (2007)

Ownership and internalization advantages explain why foreign banks invest in China. Locational advantages account for why foreign banks favor some cities. Foreign banks have established their presence in 27 Chinese cities. Shanghai and Beijing are the two most favorable locations due to a variety of locational advantages, which may include market size, banking opportunities, proximity to central bank and early openness to foreign banks (Figure 7). Shenzhen and Guangzhou rank the second tier cities in attracting foreign banks, followed by Xiamen, Tianjin, Dalian, Qingdao and Suzhou. Foreign banks have also targeted some inland cities including Harbin, Xi’an, Chengdu, Chongqing, Kunming, and Wuhan. To guide foreign banks in China, the Chinese government has taken a gradual approach to open some cities to foreign banks, allowing them to set up branch or sub-branches. This gradualist strategy has apparently guided the locational choices of foreign banks in China. Compared with branch or sub-branches which conduct currency business, representative offices, which are to collect information and understand the business environment, are more likely to concentrate in Beijing, Shanghai, Guangzhou and Shenzhen (Figure 8). The first and second headquarters of the PBC are located in Beijing and Shanghai, respectively. One of the nine regional headquarters of the PBC is situated in Guangzhou, in charge of financial matters in Guangdong, Guangxi and Hainan. Foreign banks would benefit from information spillovers and agglomeration economies by locating closer to the PBC. As a special economic zone, Shenzhen was opened to foreign banks in the early 1980s and is also close to Hong Kong, the international financial center. The geographical and institutional advantages have made Shenzhen a fairly favorable location for foreign banks.

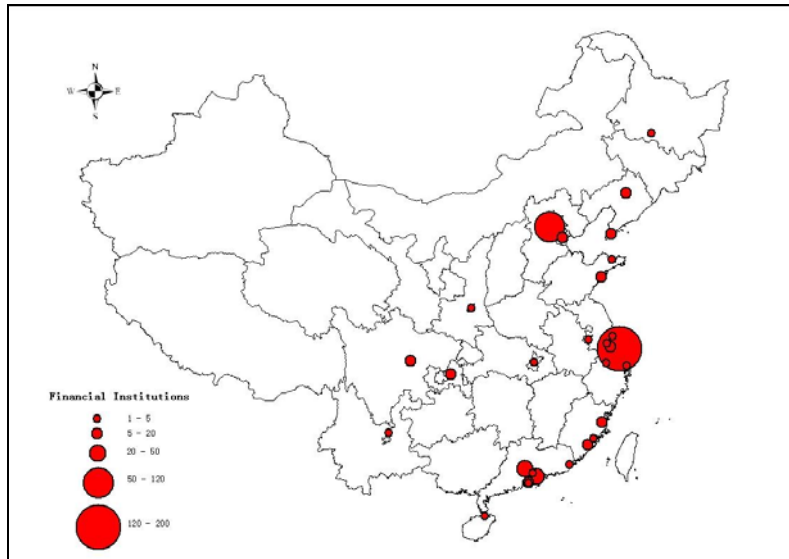


Figure 7 Distribution of Foreign Financial Institutions in China (2006)

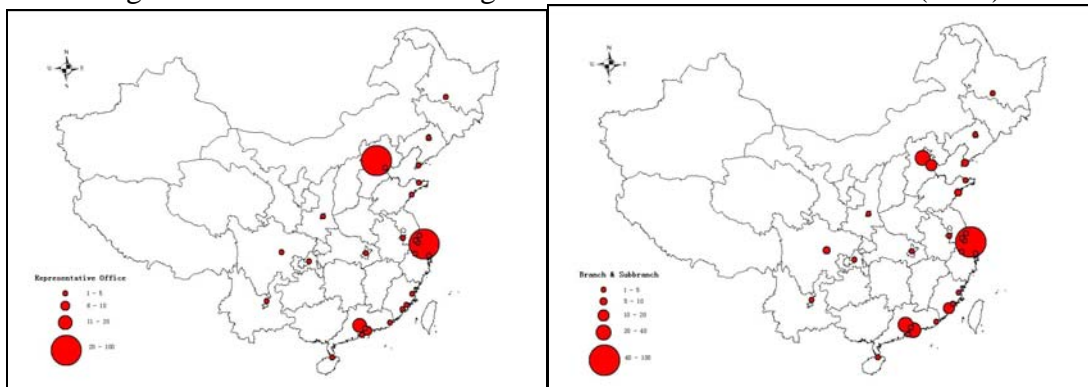


Figure 8 Distribution of Representative Offices (Left) and Branches or Sub-Branches (Right) Established by Foreign Banks in China (2006).

Data Sources: China Society for Finance & Banking (2007)

As the most important hosts of foreign banks, Beijing and Shanghai differ significantly in the entry pattern of foreign banks (Figure 9). In the 1980s, foreign banks typically set up representative offices in China to serve as an information collector. Beijing has institutional and policy advantages since foreign banks chose to establish representative offices close to the PBC in the 1980s. In 1990, the State officially opened Shanghai to foreign banks, allowing them to conduct foreign and local currency business. Foreign banks have established their strong presence in Shanghai since the early 1990s. During the post-WTO period, Shanghai has been more attractive to foreign banks. The Yangtze River Delta has recently become the most favorable region for foreign investors and Shanghai is the economic center in the Yangtze River Delta and its neighboring region. Foreign banks in Shanghai could serve a larger hinterland and market area.

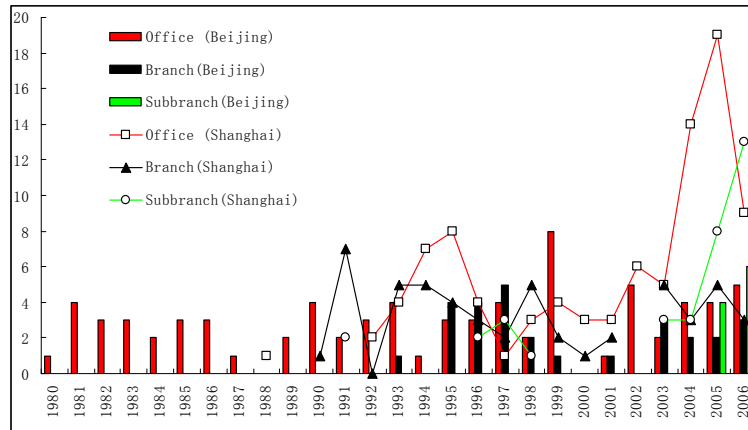


Figure 9 New Entries of Foreign Financial Institutions in Beijing and Shanghai during 1980-2006
Data Sources: China Society for Finance & Banking (2007)

Table 3 clearly illustrates the spatial diffusion of foreign banking operations in China. The Japan Import and Export bank set up a representative office in Beijing in 1980. The Nanyang Commercial Bank based in Hong Kong established a branch in Shenzhen in the following year. In the 1980s, foreign bank branches were mainly situated in the SEZs such as Shenzhen, Zhuhai, and Xiamen, and representative offices was largely concentrated in Beijing. From the early 1990s, Shanghai together with Beijing has become the hotspots for foreign banks. Tianjin, Guangzhou and Dalian joined the competition for foreign banks from the 1990s. Not until the middle 1990s, foreign banks diffused to the inland cities including Wuhan, Kunming, Chongqing and Chengdu, which are the regional economic centers.

Table 3 Spatial Patterns and Diffusion of Foreign Banks among Chinese Cities

City	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Beijing	●	4●	3●	3●	2●	3●	3●	●		2●	4●	2●	3●	4● ■	●	3● 4■	3● 4■	4● 5■	2● 2■	8● ■		● ■	5●	2● 3■	4● 2■	4● 6■	5● 9■	
Shanghai									●		■	9■	2●	4● 5■	7● 5■	8● 4■	4● 5■	● 5■	3● 6■	4● 2■	3● ■	3● 2■	6●	5● 8■	14● 6■	19● 13■	9● 16■	
Tianjin													2■	● 5■	■	3● ■	●	■						1■		2■	2■	
Shenyang														●			●								■	●■	●■	
Dalian						●	●							2■	2■	●■	2■	●									●■	2■
Qingdao													2■	1■			●							■		■		2■
Yantai																												■
Nanjing													■				●					■		■				
Suzhou																		■					●		■	●■	●	2■
Wuxi																												2■
Nantong							●																					
Hanzhou									●																■	●■	■	
Ningbo														●														
Fuzhou													●■		●						■							
Xiamen						● 2■	3■			■	● ■	● ■						■										● 2■
Guangzhou					2●								3■	● 3■	2● 5■	● ■		● ■	■	● ■			● ■		2● 2■	4● 4■	● 6■	
Shenzhen		■	■			● 2■	2■	2■	■		■			5■		● ■	■		■	■			●		6■	● 6■	● 7■	
Zhuhai								■					■	■													●	
Shantou											■	2■																
Dongguan																									●	●	■	
Haikou									■																			
Harbin																												●
Wuhan																2●	2■	■										
Kunming																●	■										2■	■
Chongqing																●		■										
Chengdu																●	●■								■	3■	2■	
Xi'an																					■							2■

Note: A: ●, Representative office; ■, Branch or sub-branch; In the case there are more than 1 representative office, or branches or sub-branches, we put a number before the symbol.

Data Sources: China Society for Finance & Banking (2007)

5. Explaining Locations of Foreign Banks in China

5.1 Modeling Locational Choice of Foreign Banks in China: A CLM Approach

This study models the locational choices of branches or subbranches established by foreign banks in China using the discrete choice technique. The goal is to understand the probability that foreign banks chose a Chinese city. In this study, the location choices of foreign banks will be modeled as a conditional logit problem. The conditional logit model assumes that foreign banks evaluate all possible city characteristics and test individual location choice against a set of alternative locations. Foreign banks choose a city with the highest expected profits.

Following McFadden (1974), the j^{th} branch of foreign bank i locating in city k will derive a profit π_{ijk} , which is composed of a deterministic and a stochastic term.

$$\pi_{ijk} = \mu_{ijk} + \varepsilon_{ijk} \quad (1)$$

where U_{ijk} and ε_{ijk} stand for a deterministic and random term, respectively. Alternative city k will be preferred by foreign bank i if

$$\pi_{ijk} > \pi_{ijl}, k \neq l \quad (2)$$

The stochastic nature of the profit function implies that probability that city k is selected by foreign bank i equals

$$P_{ijk} = \Pr ob(\pi_{ijk} > \pi_{ijl}), k \neq l \quad (3)$$

We assume that the expected profit of the j^{th} branch of foreign bank i locating in city k is a function of the observable attributes of foreign banks and characteristics of cities and a random disturbance term. The proxies represent the ownership advantages, internalization advantages and locational advantages.

$$\pi_{ijk} = \alpha_0 + \sum \phi_r O_{ir} + \sum \beta_s I_{is} + \sum \varphi_t L_{ijkt} + \varepsilon_{ijk} \quad (4)$$

where O_{ir} and I_{is} are proxies for ownership advantages and internalization advantages that the parent bank i holds. L_{ijkt} represents locational advantages in the city k that j^{th} branch of parent bank i is located

Let Y_{ij} be a random variable that indicates the city k chosen for the j^{th} branch of parent bank i , then the probability of choosing a specific city k depends upon the individual bank's attributes and the city's attributes relative to the attributes of other cities in the choice set. Following McFadden (1974), if the disturbance terms are independently distributed and they follow a Weibull distribution, then the probability of locating in city k is given by

$$\Pr ob(Y_{ij} = k) = \frac{e^{\phi L_{ijk} + \phi O_i + \beta I_i}}{\sum_k e^{\phi L_{ijk} + \phi O_i + \beta I_i}} \quad (5)$$

where O_{ir} and I_{is} represent the characteristics of the individual banks and are therefore the same for all cities. Terms that do not vary across cities fall out of the probability. Evidently, if the model is to allow individual specific effects, then it must be modified. One method is to create a set of dummy variables for the choices and multiply each of them by the common O_{ir} and I_{is} (Green, 2000). By doing this, we allow the coefficient to vary across the city choices instead of the characteristics. Each city chosen in this study is a distinct location for foreign banks. Independent variables for ownership and internalization advantages vary with parent banks and proxies for locational advantages vary with cities. For each foreign bank branch or sub-branch, 1 is assigned to the chosen city and 0 for the other cities.

This study controls the ownership advantages and internalization advantages when testing the significance of locational advantages. To test the importance of

ownership advantages, this study includes the parent bank's asset size (PBSIZE) and China-specific experience (PBCSE). The China-specific experience is measured as the number of years the parent bank has had presence in China by 2006. Data on PBSIZE are from the *Banker top 1000 World Banks 2007* and PBCSE is computed based on data from China Society for Finance & Banking (2007).

To control the impact of the internalization advantages, this study introduces three variables to test the follow the customer strategy. The first variable is the trade volume (HTRADE) that the parent bank's home country exchanges with China in 2006. The second variable is the total number of foreign enterprises (HFDI) from the parent bank's home country or region in China in 2006. Data for HTRADE and HFDI are from China Statistical Yearbook 2007. The third one is the cultural and geographical distance (HDIST) between the parent bank's home country and China. To make it simple, we classify the home economies into three categories, those from Hong Kong, Macao, Taiwan and Singapore are assigned the value of 1, those from other Asian countries granted the value of 2, and those from Europe and North America the value of 3. The cultural proximity would significantly reduce transaction costs and make it easy to realize internalization advantages.

Locational advantages explain why foreign banks favor a particular city. We test the significance of the follow the customer strategy, local market opportunity, local banking profit opportunity, relaxation of regulations on foreign banks, locations of headquarter and regional headquarters of the PBC. To test the follow the customer hypothesis, we include the total volume of international trade (CTRADE) and the total number of foreign enterprises (CFE) in a city. Per capita income (PCI) in the chosen city is applied to measure the local market opportunity. We include the total banking deposits and loans (CDDL) and the number of employees in the banking sector (EBANK) to test the significance of local banking opportunity. Information about the four variables is available from China Urban Statistical Yearbook 2007. To clarify the impact of relaxation of foreign banking regime in China, we introduce two variables proxy for policy changes. One is the number of years (CPE) for which foreign banks were allowed to establish business operational entities in a city by 2006; the other is the number of years (CRMB) for which foreign banks in a city are allowed to conduct RMB business by 2006. CPE and CRMB are calculated based on information from CBRC (2007). Finally, this study entertains two more dummy variables. One stands for the financial center in China (CFC), assigning 1 for Beijing and Shanghai, 0 for other cities. The other represents the locations of the nine regional branches of the PBC (RPBC), assigning 1 for Tianjin, Shenyang, Nanjing, Jinan, Wuhan, Shanghai, Guangzhou, Chengdu, and Xi'an, 0 for other cities. All variables are expected to have positive coefficients.

5.2 Empirical Results

This study examines the locational determinants of foreign branches or sub-branches, which conduct foreign or local currency business in China. Proxies for the attributes of city choices and the characteristics of foreign branches or sub-branches are also not correlated. Correlation analysis for the attributes of city choices indicates the existence of multicollinearity. LnPCI is strongly correlated with LnCTRADE, LnCFE, LnCDDL and CPE. LnCDDL and LnCEBANK are highly correlated. LnCTRADE and LnCFE are also strongly related (Table 4). To mitigate the multicollinearity issue in the model estimations, we drop LnPCI from the model. We also include LnCEBANK and LnCDDL in different model specifications, and treat LnCTRADE and LnCFE in the same way. To explore the impacts of characteristics of foreign branches or sub-branches, we create dummy variables for

Beijing, Shanghai, Guangzhou, Shenzhen and Tianjin, which have 10 and more branches and sub-branches. The number of branches and sub-branches in other cities is smaller than 10. We then introduce the interactions between the choice dummy variables and proxies for characteristics of foreign branches or sub-branches.

Table 4 Pearson's Correlation Coefficients between Independent Variables

	LnPCI	LnCBDL	LnCEBANK	LnCTRADE	LnCFE	CPE	CRMB	CFC	RPBC
LnPCI	1								
LnCBDL	0.5149	1							
LnCEBANK	0.3167	0.9298	1						
LnCTRADE	0.8687	0.6709	0.5287	1					
LnCFE	0.7477	0.4662	0.3669	0.7714	1				
CPE	0.5192	-0.1071	-0.2492	0.3751	0.2552	1			
CRMB	0.3565	0.528	0.5358	0.462	0.3129	0.2876	1		
CFC	0.2126	0.4286	0.4584	0.2981	0.3139	0.1382	0.5734	1	
RPBC	-0.0056	0.5978	0.633	0.1389	-0.0264	-0.2832	0.4411	0.2545	1

The regression results based on the conditional logit model is reported in Table 5. The LM tests show the significance of different model specifications. The statistical results provide strong evidence to support that locational advantages guide the geographical distribution of foreign banks. First, banking opportunities and banking sector size in Chinese cities are critical factors affecting locational decision of foreign banks. Foreign banks are more likely to locate in cities with larger total banking deposits and loans, indicated by the positive significant coefficients on LnCBDL (the log of total banking deposits and loans in a city). Larger deposits and loans in a city mean more banking opportunities. The positive significant coefficients on LnCEBANK suggest that foreign banks are drawn to cities with a large number of employees in the banking sector. Foreign banks choose to locate in those cities to benefit from the skilled labor pool and information spillover effects. Being aliens, foreign banks may suffer information asymmetry and encounter serious business risks. Locating in cities with more banking opportunities and good financial conditions could mitigate business uncertainty and risks. Second, there is weak evidence to support the follow the customer hypothesis. Foreign banks are found to significantly favor cities with a large volume of international trade. The coefficients on LnCFE however are statistically insignificant, indicating that foreign enterprises may not march foreign enterprises. Foreign banks in China may mainly follow the international traders rather than foreign investors.

Third, the gradual approach to open Chinese cities to foreign bankers is found to have a significant impact on the locational choice of international banks. CPE is the number of years for which a city had allowed the establishment of operational entities by foreign banks by 2006. In different model specifications, the coefficients on CPE are positive and statistical significant, implying that foreign banks are more likely to choose the early opening cities. CRMB is the number of years for which a city had allowed foreign banks to conduct RMB business by 2006. The coefficients on CRMB turn positive and significant only when introducing the characteristics of individual foreign branches and sub-branches. The conditional significance suggests that cities allowing RMB business attract some foreign banks. As a matter of fact, Jinan, Ningbo, Harbin, Changchun, Lanzhou, Yinchuan and Nanning had allowed foreign banks to conduct RMB business by 2005, but with no branches or sub-branches by 2006.

Finally, statistical results suggest that foreign banks significantly favor cities hosting headquarters and regional headquarters of the PBC. The coefficients on CFC

(the dummy variable for Beijing and Shanghai, which host the headquarters of the PBC) and RPBC (the dummy variable for cities hosting the nine regional headquarters of the PBC) are positive and significant at 10% level in most model specifications. The geographical proximity to the PBC allows foreign banks to have easy access to the financial policy decision-makers and build localized business networks. Informational externalities associated with being geographically close to the PBC would significantly moderate business risks and uncertainties encountered by foreign banks.

Table 5 Results of Conditional Logit Regression for Foreign Branches and Sub-branches

Variables	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
LnCBDL	0.6481***	0.5891*	1.0039***	0.9445***				
LnCEBANK					0.6670***	1.0550**	1.0350***	1.3412***
LnCTRADER	0.2560**	0.1766			0.3073***	0.2414**		
LnCFE			0.0141	-0.0513			0.1317	0.0671
CPE	0.1757***	0.1322***	0.2022***	0.1631***	0.1840***	0.1952***	0.2248***	0.2307***
CRMB	-0.0239	0.1803**	-0.0165	0.2044***	-0.0270	0.1030	-0.0246	0.1194
CFC	0.4825**	3.8082***	0.3880	3.8000***	0.3985	3.7866***	0.1795	3.7791***
RPBC	0.8666***	0.2895	0.6637***	-0.0003	0.9301***	0.5959*	0.8406***	0.4784
SH*LnPBSIZE		0.1880		0.1878		0.1885		0.1881
SH*PBCSE		-0.0994***		-0.0999***		-0.1013**		-0.1016***
SH*LnHTRADE		-0.4707**		-0.4913**		-0.5342**		-0.5492**
SH*LnHFDI		0.1850		0.1958		0.2180		0.2259
SH*HDIST		0.5623*		0.5670*		0.5775*		0.5806*
BJ*LnPBSIZE		0.4851**		0.4856**		0.4809**		0.4819**
BJ*PBCSE		-0.1134**		-0.1137**		-0.1157**		-0.1158**
BJ*LnHTRADE		-0.7825**		-0.7872**		-0.8858**		-0.8781**
BJ*LnHFDI		0.6994*		0.7013*		0.7562*		0.7513*
BJ*HDIST		1.0531*		1.0540*		1.0829*		1.0803*
SZ*LnPBSIZE		0.0542		0.0542		0.0548		0.0548
SZ*PBCSE		-0.0893*		-0.0898*		-0.0903*		-0.0904*
SZ*LnHTRADE		-0.0468		-0.0740		-0.0769		-0.0835
SZ*LnHFDI		0.1249		0.1387		0.1408		0.1442
SZ*HDIST		-0.0356		-0.0278		-0.0280		-0.0260
GZ*LnPBSIZE		0.2277		0.2279		0.2283		0.2284
GZ*PBCSE		-0.0241		-0.0242		-0.0250		-0.0249
GZ*LnHTRADE		-0.5016		-0.5038		-0.5365		-0.5334
GZ*LnHFDI		0.5027		0.5035		0.5197		0.5178
GZ*HDIST		0.6795		0.6799		0.6871		0.6862
TJ*LnPBSIZE		0.3866*		0.3884*		0.3883*		0.3892*
TJ*PBCSE		-0.1163*		-0.1164*		-0.1177*		-0.1177*
TJ*LnHTRADE		-0.5655		-0.5517		-0.6054		-0.5976
TJ*LnHFDI		0.5047		0.4963		0.5246		0.5199
TJ*HDIST		0.8285		0.8235		0.8376		0.8349
Log-likelihood	-675.62	-630.71	-678.14	-631.41	-674.32	-629.18	-678.45	-631.16
x ²	582.64	672.46	577.60	671.06	585.25	675.52	576.98	671.55
Pseudo R ²	0.3013	0.3477	0.2987	0.3470	0.3026	0.3493	0.2984	0.3473

Note: 1. SH, BJ, SZ, GZ and TJ are dummy variables for Shanghai, Beijing, Shenzhen, Guangzhou and Tianjin

2. ***, **, * denote significance at the 1%, 5% and 10% levels, respectively.

Statistical results also suggest that parent banks may influence the locational choices of foreign branches and sub-branches in China. First, whether foreign banks

possess ownership advantages is found to affect their locational choices within China. The interactions between the city dummies and LnPBSIZE have positive coefficients, suggesting that larger parent banks are more likely to enter those favorable cities. The size effect is particularly significant for Beijing and Tianjin, implying that top banks in the world significantly favor Beijing and Tianjin over others. The negative coefficients on the interactions between the city dummies and PBCSE indicate that new comers significantly prefer Shanghai, Beijing, Shenzhen and Tianjin. Relatively speaking, late comers lack sufficient China-specific business experience and knowledge, and choose to locate in Beijing, Shanghai, Shenzhen and Tianjin to mitigate business uncertainties or take advantage of informational externalities.

Second, there is some evidence to show that locations of foreign banks in China are partially dependent on whether foreign banks have internalization advantages. Coefficients on SH*LnHTRADE and BJ*LnHTRADE are negative and statistically significant at 5% level. Other coefficients are also negative but insignificant. The findings suggest that foreign banks from smaller countries, which have less significant trade linkages with China, are largely concentrated in the most favorable locations, in particular, Shanghai and Beijing. Compared with multinational banks based in the dominant economies such as Japan, the United States, Germany and United Kingdom, banks from smaller economies lack competitive ownership and internalization advantages. Locating in Shanghai and Beijing is the best locational choice for their success in China. All coefficients on the interactions between city dummies and LnHFDI are positive, but only significant for Beijing. Foreign banks from countries with a large number of foreign enterprises in China would be more likely to choose Beijing to establish branches or sub-branches and to serve corporate customers from their home countries. The country of origin of foreign banks is found to have significant impacts on their locational choices in China. Multinational banks from Europe and North America are more likely to establish branches or sub-branches in Shanghai and Beijing. The coefficients on GZ*HDIST and TJ*HDIST are also positive. Cultural and geographical distance has motivated foreign banks to locate in the financial centers. Externalities associated with the financial sector in those cities would help offset the cultural and geographical barriers. Due to the geographical proximity to Hong Kong, banks from Hong Kong and Macao are more likely to concentrate in Shenzhen, shown by the negative coefficient on SZ*HDIST. Those banks are likely to provide services for enterprises from Hong Kong and Taiwan. To take advantages of the geographical proximity, banks could easily keep the original bank-client networks developed at home. The conditional logit model allows the inclusion of both the attributes of city choices and the characteristics of individual investing banks. This technique permits us to explore the significance of locational advantages controlling for foreign banks' ownership and internalization advantages. The statistical analysis implies that the eclectic paradigm of international banking provides a powerful theoretical framework for understanding foreign banking activities in China.

6. Conclusions and Discussions

China has gradually implemented reforms in its banking sector and has relaxed restrictions on foreign banking investments step by step. Right after the open-door policy, China allowed the Japan Import and Export bank to set up its representative office in Beijing in 1980. Since the middle 1980s, the State has gradually permitted the establishment of business operational entities by foreign banks initially in the SEZs, then in other coastal cities and later in the inland cities. From 1990, the Chinese government allowed foreign banks in Shanghai to conduct RMB business and later

expanded to 25 cities by the November 2006. Foreign banks were guaranteed phased access to the Chinese market with the elimination of all restrictions on their business activities by the end of 2006.

The gradual approach of reforms and deregulations has indeed guided foreign banks to enter the Chinese market. Foreign banks initially concentrated in the SEZs and Beijing, later diffused to Shanghai, Tianjin, Dalian, Guangzhou and other coastal cities. Recently, foreign banks started to build up their presence in some inland cities. The statistical analysis confirms that banking opportunities and externalities associated with financial centers do affect the locational choices of foreign banks in China. Meanwhile, foreign banks are found to significantly favor cities with fewer restrictions on foreign banking activities. There is also some evidence to support the follow the customer hypothesis. Foreign banks tend to locate in cities with a large volume of international trade, and those from countries with a large number of foreign enterprises in China are more likely to choose Beijing to set up branches or sub-branches to serve their customers. Individual data and the discrete choice modeling technique allow us to explore how the characteristics of investing banks affect the locations of foreign banks. The investing banks' asset size and China-specific business experience significantly influence their decisions about whether to choose Beijing, Shanghai, Shenzhen and Tianjin. An investing bank's country of origin indeed affect whether it chose Beijing and Shanghai to set up branches or sub-branches.

From 2007, the Chinese government lifted all customer and geographical restrictions on foreign banks. Theoretically speaking, foreign banks could choose any cities in China to establish branches or sub-branches. However, our analysis suggests the significance of externalities and first-mover advantages in the locational choices of foreign banks. In a transitional economy like China, foreign banks would encounter significant business uncertainties and risks. Agglomeration economies in banking sector would help the survival and success of foreign banks in China. The financial centers and regional centers in China would expect more entries of foreign banks. The local banking sector would benefit from the introduction of foreign branches or sub-branches since foreign banks would intensify market competition, bring new management skills and experience, and create new products and practices.

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