Working with Financial Markets: Beyond the Third Party Plenum

by

Professor the Honourable Joseph Yam, GBM, GBS, CBE, JP

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The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

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I. Introduction

1. Throughout my nearly forty years as a public officer, I had the privilege of working closely with markets, mostly in the capacity as a policy maker and in the monetary and financial areas. The experience had overall been a fascinating one. Hong Kong has for a long time been among the freest economies in the world. With the economy built on a barren rock with no natural resources, Hong Kong embraced market freedom most enthusiastically. Uniquely, from 1997 on the resumption of sovereignty over Hong Kong by China, the free flow of capital formally became a legal requirement, as spelt out in Article 112 of the Basic Law. With Hong Kong's financial markets being small relative to the ever increasing volume of international capital participating in them, there has been no lack of excitement. On a few occasions, the market, as a long time trusted friend, did inflict a lot of pain on the community and cause considerable personal agony on my part. However, the friendship remained strong throughout, although I did, in my capacity as a policy maker, have to exercise my authority on those occasions to remind this trusted friend what the public interest was and of the need to behave.

2. It was also with great excitement that I read in the middle of November 2013 the Decisions of the Third Party Plenum and noticed the strong emphasis, in deepening economic reform, to allow the market to play a decisive role in resource allocation on the Mainland of China. This was so prominent in the Decisions document and in subsequent public communications by leaders of the country that some commentators have rated the

[*] Distinguished Research Fellow, Institute of Global Economics and Finance, The Chinese University of Hong Kong. The opinions expressed herein are those of the author and do not necessarily reflect the views of the Institute.

significance of the Decisions as comparable to that of the “Reform and Liberalization” initiative taken at the Third Party Plenum of 35 years ago.

3. Outside of the Mainland, we have inadequate appreciation of how a “socialist, market economy” works. And some of us, perhaps reflecting this ignorance, often simplistically point out that there is a contradiction in terms inherent in that description of the political economy of the Mainland of China. Yet, interestingly, we notice the greater efficiency in the policy transmission mechanism in the socialist market economy of China, where decisions taken by the State Council are enthusiastically and effectively implemented, enabling for example the Mainland to sail through unscathed two most severe regional and global financial crises over the past 15 years. But, at the same time, we also notice the lower efficiency in resource allocation, with the relevant decisions being influenced, or even taken, by Party Secretaries at various levels of government, instead of being left to the market. Consequently, there are roads that lead to nowhere, and money does not necessarily go to those who are creditworthy. It would certainly be the right thing to do to enhance the efficiency in resource allocation on the Mainland of China by allowing the market to play a decisive role; and if this can be achieved without compromising the efficiency of the policy transmission mechanism it would be ideal.

4. We all should observe closely and with an open mind how this new initiative of the Third Party Plenum held in November 2013 is to be implemented in the various key sectors of the economy of the Mainland of China and what benefits would be derived from it. As someone who is reasonably familiar with the functioning of financial markets, I have a few opinions to offer, first, at a general level in Section II, calling for both caution and courage in allowing the market to play a decisive role in resource allocation. In Sections III and IV, I discuss more specifically the possible reform measures that could be adopted respectively in the money and foreign exchange markets to realize this safely and effectively. My views and, where relevant, recommendations are summarized in Section V.

II. Market Theory and Practice

(1) Absence of Perfectly Competitive Markets

5. I do not intend here to rehearse the theoretical or philosophical arguments concerning the superior efficiency of the market in resource allocation, other than to confirm my general agreement and to recall the academic position postulating the ability of perfectly competitive markets to achieve equilibrium allocation of resources which is Pareto optimal. In layman terms, this means a situation in which no one can be made better off without hurting the interests of others. In this connection and speaking from experience, I wish to point out, however, that perfectly competitive markets do not exist in practice. I have not been able over the many years of studying and working with markets to find even one that fits the academic description of a perfectly competitive market. If anybody can identify an actual example of one such market, I would be most happy to be enlightened.

6. A quick look at the necessary (but may not be sufficient) conditions for perfect competition illustrates this clearly: absence of monopoly power, free entry and exit, price-taking behavior, full information and negligible search costs, product homogeneity and divisibility, lack of collusion, negligibility of an individual's quantities relative to aggregates, etc, etc. In the real world, many of these conditions are hard to come by. The reality is that different types of market imperfections prevail and to varying degrees of severity, although not always to the extent of undermining the generally accepted superiority of the market, compared with bureaucratic directions, in achieving more efficient allocation of resources. Markets do fail, hopefully only occasionally, in achieving an outcome in the allocation of resources that is Pareto optimal. When such market failure occurs, it means that we have a situation in which the community, or at least a significant part of it, can be made better off and not at the expense of others through Pareto-improving market interventions by those responsible for promoting and protecting the public interest.

(2) Politics of Market Intervention

7. But it is not always easy for the authorities to identify market failure, at least before it is too late, and come up with a strategy for market intervention that is clearly Pareto-improving. Take the example of a possible meltdown of the financial system, caused by non-competitive market behavior of a few who seek to move prices in their favor, and in a position to do so, rather than being price-takers. The convenience of taking the moral high ground, waving the free market banner and doing nothing, is always attractive for the authorities, supported by the few politically influential market participants with short-term vested interests that are against the long-term public interest. And soon it becomes too late and the meltdown materializes, leading to a prolonged breakdown of the all important function of the financial system in financial intermediation. The providers of funds – the investors – loss large amounts of money and the borrowers, however credit-worthy they may be, face a sharp drop in the availability of funds and, where funds are still available, a sharp hike in borrowing costs.

8. Even if potential market failures are identified in a timely manner, it is always hard for the authorities to come up with market intervention proposals that can unequivocally be demonstrated as Pareto-improving and receive political support for them and for their timely implementation. Some of us will remember the controversy surrounding the stock market intervention in Hong Kong in August 1998. And, up to this moment, while clearly much of the community benefited from the intervention, I am still not sure that the action was Pareto-improving, as I imagine those who had shorted the market were hurt, although there was little sympathy for them in the community. Also consider the controversy and the time needed if general anti-trust legislation is to be proposed, debated and passed in Hong Kong to deal with non-competitive behavior. Although in the public interest, the probability of this delicate subject being successfully pursued in Hong Kong is, regrettably, virtually zero. Thankfully, the mechanism for policy making in the socialist, market economy of the Mainland of China is rather more efficient.

9. There is simply a fundamental need, while leaving the market to play a decisive role in resource allocation, continuously to monitor the performance of the market and objectively assess its outcome against the public interest. For most of the time, the conclusion should be a positive one of not intervening in the functioning of the market. But whenever, in the opinion of the responsible policy makers, market failure occurs or threatens to occur to the extent of hurting the public interest, Pareto-improving market interventions, which are clearly in the public interest, must decisively be taken. Interestingly, this is precisely what the much misunderstood phrase "positive non-interventionism" means, something that I can confirm as someone who was involved in discussions leading to the coining of that phrase in policy making in Hong Kong in the 1970s.

(3) Use of Authority over Markets

10. Starting from a position where there is already extensive involvement of government in the economy, the pre-occupation on the Mainland in implementing the initiative of allowing the market to play a decisive role in resource allocation would generally be more of one of reducing rather than increasing government involvement. This would not be easy. Authority, in whatever form and in whichever area, has an understandable tendency of being treated by those who are responsible for exercising them as a source of institutional or, regrettably, even personal benefits. This is particularly so if the incentive system for the authority holders is such that the remuneration for them is disproportionately low relative to the responsibilities that they carry. Therefore, the resistance in giving up authority arising from the desire to protect vested interests would be intense. It requires considerable courage and political skills to relinquish authority, even if this is for the public good. In any case, it would help if the exercising of authority over markets can be transparently prescribed. Where authority needs to be exercised, a rule-based system often commands a higher degree of credibility and confidence than a discretion-based system, although the former limits the flexibility on the part of the authorities to handle special circumstances.

11. The possibility of the incentive system for participants in the market, including the regulators, being not conducive to achieving efficient allocation of resources by the market is a much more difficult and complex issue, insofar as the Mainland is concerned. As described in the Manifesto of the Party and reiterated in the November 2013 Decisions document of the Third Party Plenum, "a fundamental economic system characterized by a public ownership system as the main body developing together with a variety of private ownership systems is the important pillar of Chinese style socialistic system and the foundation of the socialist market economy". I am not qualified to comment on this important political statement. But I am aware of the argument put forward by some that private ownership provides the necessary stimuli (in the form of the expected returns) and the constraints (in the form of the financial responsibility) to innovative decisions involving risk. In other words, private ownership provides the motivational foundation of market-type managerial behavior. This argument carries the implication of lower efficiency in resource allocation by the market being associated with public ownership. But I am also aware of the counter argument that this could be addressed by the separation between ownership and management. This seems an important area for further consideration.

(4) The Fundamental Conflict of Interest

12. A totally different area in which I would like to offer my opinion concerns the markets in the financial system. They are most important in that they are responsible for the allocation of financial resources, through channeling funds from those who have a surplus of it – the depositors and investors – to those who are in need of it – the fund raisers, thereby supporting general economic activities. Because of the mismatch between the risk appetites of depositors and investors and the risk profiles of fund raisers, there is a need for financial intermediaries to transfer, transform and transact risks. The way how the financial intermediaries perform their roles has an important bearing on the efficiency of the financial system in the allocation of funds.

13. Experience in the past twenty years, in developing as well as developed markets, characterized by the occurrence of debilitating financial crises, has shown that the financial intermediaries, very much left to their own devices and lightly supervised, have simply not performed these roles well. At the heart of the problem, as I see it, is a fundamental conflict between the private interests of the financial intermediaries in maximizing profits and bonuses and the public interest of achieving efficient financial intermediation. In the medium to long term, the higher the profits and bonuses of the financial intermediaries, by definition the larger is the intermediation spread and the lower is the efficiency of the financial system.

14. Yes, we did have short periods in which high profitability of the financial intermediaries coincided with high investment returns for those with surplus funds and low costs of borrowing for the fund raisers. The financial intermediaries attributed this to their innovative efforts and for that they extracted attractive remuneration. But this anomaly of high profitability for financial intermediaries and low intermediation spread is unsustainable. Financial innovation regrettably often leads to an erosion of standards and a built-up of unfamiliar and systemic risks, which eventually turns into financial crises when the intermediation spread widens sharply. Investors are then hit by sharply negative returns and credit-worthy fund raisers are denied access to funds. Past experience has shown that the short-term anomaly is made possible only through, in academic terms, an inter-temporal transfer of the intermediation spread from the future to the present and largely into the coffers of the financial intermediaries.

15. Thus the attitude of the authorities towards financial markets and the financial intermediaries needs to be cognizant of this fundamental conflict, which has time and again undermined the efficiency of the financial system in the important role of allocating financial resources. And financial intermediaries, being in a position to control where money comes from and where it goes, do command a strong political lobby in democratic capitalist societies, to the extent that the attitude of the authorities has become one of general neglect, eschewing regulation of financial markets and supervision of financial institutions, again conveniently waving the free market banner. As a consequence, financial intermediaries in capitalist economies have come to consider financial markets

as their playground for making money, rather than as the platform for supporting the economy. Hopefully this is changing, as regulators consider in the various international financial forums lessons learnt from the recent financial crisis. Compensation arrangements in financial intermediaries have, rightly, become one important area for supervisory monitoring. Although in the socialist market economy of the Mainland of China, the politics of finance is thankfully different from that in democratic capital economies, the fundamental conflict exists all the same.

III. The Money Market

(1) The Requirement of Monetary Policy

16. The Decisions document of the Third Party Plenum emphasized that, in reforming the economic system, the core issue is to rationalize the relationship between the government and the market, allowing the market to play a decisive role in the allocation of resources and the government correspondingly to function more effectively. There is considerable scope in the money market on the Mainland of China for reform in accordance with this spirit.

17. It is important first to recognize that, in any jurisdiction with its own currency, there is an indispensible need on the part of government, through a central banking institution, to exercise effective influence over the supply or the price (or both) of money denominated in the domestic currency that is serving as the medium of transaction, a store of wealth and a unit of accounting in the domestic economy. Indeed, this is the fundamental requirement in the conduct of monetary policy, whatever the objective of that policy may be. Specifically, the influence is exercised through controlling the supply and price of that part of base money representing the total of the balances maintained in the clearing accounts of the commercial banks held at the central bank. (The other part of base money, being domestic currency notes and coins in circulation, largely a reflection of the demand for money as a medium of retail transactions, has little significance in the conduct of monetary policy.) Other than this essential involvement of the central bank in controlling base money, the rest of the money market can largely be left on its own to allocate funds denominated in the domestic currency, channeling money from those who have a surplus of it to those who are in need. This would be done at market prices reflecting the risk appetites of depositors and investors, and the risk profiles or credit worthiness of fund raisers, and guided by the price of base money as determined by the central bank as a matter of monetary policy.

(2) Control over the Supply of Money

18. On the Mainland, the usual power of influence over the supply of money exists. The People's Bank of China (PBOC), as the central banking institution, has absolute control over the supply of base money, given that, as in other jurisdictions, all commercial banks maintain clearing accounts with the central bank. The supply of base money, nevertheless, is not the same as the money supply, as variously defined, which has a significant, some say strong, effect on economic activities. Thus, some central banks engage in influencing the growth rate of the money supply as an intermediate monetary policy target. This is done principally through establishing, by administrative authority, a mandatory relationship between the balance that a commercial bank maintains at its account at the central bank for the clearing of interbank transactions with the amount of customer deposits taken by that commercial bank, which falls directly into the definition of the money supply. This mandatory relationship is usually referred to as a reserve requirement, the clearing balance as the reserve balance, and there is a reserve requirement ratio (RRR), as in the case of the Mainland of China, determined as a matter of policy, by the central bank. By varying the RRR, and therefore the adequacy of the clearing balance or the reserves held by a commercial bank at the central bank, it is hoped that the growth rate of the money supply on the one hand, and the ability of the commercial banks to extend loans on the other, can be effectively influenced.

19. Whether or not targeting and influencing the money supply through controlling the supply of base money by an RRR is an effective way of conducting monetary policy is debatable. I do not wish to enter into such a debate here, other than to point out that targeting money supply growth has gone out of fashion in central banking. There is now much more focus in central banking in controlling the price of base money and hence the price of money generally, rather than the supply. In the case of the Mainland of China, there is still a target for the money supply (13% in 2013) mentioned in communications by the authorities, but I sense that the significance of this target, or the seriousness with which the PBOC treats this target, has been declining, somewhat in line with international practice. One explanation of the generally reduced enthusiasm in the use of a money supply target in the conduct of monetary policy amongst central banks can

perhaps be found in Goodhart's Law, which postulates that, once transparently announced, the effectiveness of the target in achieving the objective of monetary policy is likely to wane over time, as activities in the money market find a way to avoid being caught by the target. What seems more relevant in moving away from targeting the money supply on the Mainland of China is the rapidly falling ratio of bank loans as a percentage of the total scale of social financing or funding for the economy: from 92% in 2002 to 52% in 2012 (and 51.4% in 2013).

20. I think it is time that the PBOC should formally do away with the money supply target in its conduct of monetary policy. This in effect would make the reserve requirement, and the RRR as a monetary policy tool, largely redundant, and therefore to be phased out over a period of time, which will have the effect of enhancing the efficiency in the allocation of financial resources. Some may still be attracted by the use of RRR in managing interbank liquidity, given that a variation of it has an almost immediate effect of restraining or relaxing the liquidity available to banks to support their lending. But I would say that the use of the RRR in this manner is arguably inappropriate as there should always be adequate liquidity in the banking system, at an appropriate price of course, to support prudent lending to those who are credit-worthy, subject to capital adequacy and other prudential regulatory considerations.

21. It is important to recognize that the reserve requirement is in effect a tax on the banking system that undermines its efficiency in supporting the economy. The RRR on the Mainland of China now stands at around 20% and the reserves held at the PBOC are currently paid 1.62% (last changed in November 2008). Excess reserves are paid 0.72%. This means that the commercial banks are involuntarily holding onto a very significant amount of assets, equivalent to 20% of their deposits (totaling over RMB 100 trillion), earning a very low rate of return, whereas they have to pay, say, 3% for a one-year deposit. This earnings deficit arising from the reserve requirement, which runs into hundreds of billions, is being made up by a net interest margin, appropriately defined, that is higher than otherwise would be the case, in order that the banks can sustain profitability. Borrowers therefore are in effect forced by the reserve requirement to pay significantly more for funds and depositors receive significantly less interest income, and

by definition this means a higher intermediation spread in, and lower efficiency in financial intermediation by, the banking system. And it is not as though the authorities are financially benefiting from that tax and can use the revenue to enhance community welfare. The PBOC is in fact hard pressed to make a profit on the foreign assets corresponding to the reserve balance liabilities (about RMB 20 trillion, costing 1.62%), given the appreciating renminbi (3% in 2013 against the US dollar). The reserve requirement is in effect forcing depositors and borrowers on the Mainland of China to subsidize borrowers in foreign jurisdictions, such as the United States government.

22. One remaining case for controlling the supply of base money concerns the situation when the price of base money, as a monetary policy instrument, is already zero bound. We see of course the recent experience of the developed markets, in particular the United States, in quantitative easing. My view, however, is that increasing the size of base money to promote economic recovery has its limits. Excess reserve balances of commercial banks held with the central bank, in other words an excess of liquidity in the banking system, do not necessarily lead to more bank lending in support of the economy. Credit risks concerns, particularly in an economic downturn, and capital adequacy constraints limit the desire on the part of the banks to lend. The tendency is for the banks with excess liquidity to deploy it in financial market activities, particularly those relating to financial assets that the central bank is purchasing in the context of quantitative easing. But, of course, buoyant financial asset prices, supported by asset purchases by the central bank, do generate a favorable wealth effect in the economy. I would further say that it is not quantitative easing as such that has promoted economic recovery in the United States. It is the skilful and imaginative management of expectation on the future movement of the price of money by the Federal Reserve Bank (FED), working on interest rates along the yield curve and tying policy reversal to the inflation and unemployment rates, which did the trick. Whether the balance sheet of the FED, and hence liquidity in the hands of the banks, is at four trillion or one trillion US dollars makes not a lot of difference. One simply cannot push an elephant with a string. Insofar as the Mainland is concerned, interest rates are happily not zero bound and the economy is cruising along at a comfortable and enviable speed. Quantitative easing is simply not a policy option that needs to be considered at this time. The important point to note, however, is that the

monetary policy framework on the Mainland allows for this, if ever a need to resort to it is identified.

(3) Control over the Price of Money

23. The common practice, in modern central banking, is for the central bank to exert indirect influence over the price of money, or interest rates, generally, through direct control over the price of base money. On the Mainland, the power of control of the PBOC over the price of money, or interest rates, is quite extensive, perhaps unnecessarily so. The interest rates currently determined by the PBOC can conveniently be divided into two categories: those that are applicable to the business relationships between the banks and their customers and those that are applicable to the policy oriented relationships between the PBOC and the banks.

24. Insofar as those interest rates applicable to the customers of commercial banks are concerned, very simply the PBOC need not be involved and those rates should be left to be determined by the commercial banks operating in open competition. Currently there are still benchmark deposit and lending rates determined and published by PBOC, the last occasion being in July 2012, although various exceptions have been introduced to allow the banks freedom to float deposits rates upwards (by a factor of 1.1 effective from June 2012) and lending rates downwards (by a factor of 0.8 effective from June 2012 and 0.7 from July 2012). And just recently in July 2013, the downward float of 0.7 was eliminated altogether in the sense that the lending rates of the commercial banks were freed up, other than for residential mortgage lending, effectively making the benchmark lending rates redundant, again except for mortgage lending. But there is no reason why the mortgage lending rates should not be left also to be determined by the banks in competition. There are other mechanisms for the prudential supervision of mortgage lending; and in any case such supervision should be oriented towards the maintenance of banking stability rather than as a matter of monetary policy or indeed other public policies, desirable as they may be. In other words, the PBOC could easily just abolish

those redundant benchmark lending rates, if only as a demonstration of its desire to reform in accordance with the spirit of the Decisions document of the Third Party Plenum.

25. Liberalization of deposit interest rates is more delicate. Keen competition for deposits can generate risks that may be difficult to manage particularly if those risks turn out to be of a systemic nature. Hong Kong took more than a few years to eliminate the Interest Rate Rules of the Hong Kong Association of Banks. With concurrent strengthening of prudential supervision of the banks, that exercise was happily a successful one. There is no reason why this should be any different on the Mainland, particularly when there is intention for the introduction of deposit insurance, which helps to limit systemic risks through enhancing depositors' confidence in the banking system. I am sure the Mainland authorities have already figured out what strategy to adopt for the liberalization of deposit interest rates. As an observer, I think the preferable sequence may be, on the size dimension, from wholesale to retail deposits, and, on the maturity dimension, from long term to short term deposits.

(4) A Policy Rate

26. Interest rates applicable to activities between the PBOC and the banks are either monetary policy oriented or for prudential purposes. Currently, the PBOC determines the following interest rate levels:

(a) Interest rate paid on reserves held by banks at the PBOC in accordance with the reserve requirement. This currently is 1.62% and was last changed on 27 November 2008. Interest rate paid on excess reserves held by banks at the PBOC is currently at 0.72%. The RRR itself, as discussed earlier, is an administrative requirement relating reserves held by a bank at PBOC with total deposits taken by the bank and varies between different categories of banks (now at around 20%).

(b) A set of lending rates for various maturity periods applicable to direct lending by the PBOC to the banks. These were last changed on 26 December 2010, ranging from

3.25% for 20-day money to 3.85% for one-year money. There is also a rediscount rate at 2.25%. The purpose of this set of lending rates has changed over time from being one of the significant tools for adjusting the supply of base money to one used for lending guidance, as the PBOC switched gradually to relying on open market operations to make adjustments to base money.

(c) But, more recently (early 2013), the PBOC introduced a Standing Lending Facility (SLF) to help liquidity management by the country-wide commercial banks and the policy banks, providing money of one to three months maturity at unpublished interest rates determined by the PBOC.

(d) Interest rates used in open market operations. The PBOC conducts different types of open market operations: repo, which withdraws liquidity or reduces base money for the relevant period (7-day, 14-day, etc); reverse repo, which injects liquidity or increases base money for the relevant period; and, more recently, Short Term Liquidity Operations (SLO), for example, for 2-day money. The repo and reverse repo rates vary. The reverse repo rates being used recently are 4.1% for 7-day money and 4.3% for 14-day money. Information on the SLO lending is published with a rather long time lag at the end of the month following the month on which action was taken, unlike that for the open market operations, which is published on the same day. The PBOC supplied 2-day money on two occasions through SLO at 4.5% in October 2013 and 3-day money once at 4.7% in November 2013. In the second half of December 2013, supplying liquidity through SLO became more frequent and for the first time at the end of the month the PBOC withdrew surplus liquidity through it.

(e) Other interest rates determined by the PBOC include those applicable to bills issued by the PBOC and those for cash management deposits of the government placed with commercial banks. But these interest rates do not seem to be of significance to the conduct of monetary policy by PBOC, although the interest rates of bills issued could be so construed.

27. One immediate impression, looking at this extensive spectrum of interest rates determined by the PBOC, is the lack of a prominent policy rate akin to, for example, the Fed Funds Target Rate in the United States, which is closely observed by all and serves as an indispensible and reliable element for price discovery in the money market – a piece of information essential to the effective functioning of the economy. The PBOC does not have a target level of interest rate for short term (for example, overnight) money that it transparently announces after monetary policy deliberations by a monetary policy committee and then through open market operations seek to influence the price of money of that maturity in the wholesale inter-bank market against the target, supplying or withdrawing liquidity as demand varies day by day. Consequently, when, for whatever reasons (including unsophisticated management of liquidity by commercial banks or large daily discrepancies between government revenue and expenditure), demand or supply of base money shift significantly relative to each other, the inter-bank interest rates, in the form of the Shanghai Interbank Offered Rate (SHIBOR), at different maturities, fluctuates sharply. There were, for example, a couple of occasions of sharp hikes in SHIBOR in 2013, resulting in misguided and unhelpful market expectation of possible monetary tightening by PBOC, very much against the pronouncement of stable monetary policy being pursued.

28. What seem to me to have more monetary policy significance, at least during 2013, were the interest rates used by PBOC for reverse repos (supply of liquidity) of 7-day and 14-day maturities, which stood at 4.1% and 4.3% respectively during the five months from August to December 2013. They are not so much targets, because against a stable monetary policy stance continuously emphasized by the State Council and PBOC, they were allowed to move higher in 2013. But they are at least transparently disclosed as soon as the relevant open market operations have been conducted. Regrettably, however, there is no formal timetable for open market operations, other than the usual practice of conducting them on Tuesdays and Thursdays. And when, for whatever reasons, such as substantial inflows of capital necessitating exchange market intervention by PBOC that involved the injection of RMB liquidity, there is a pause in the conduct of reverse repos, once again unhelpful talks about possible monetary tightening abound. Thus, there is a need for the PBOC to come up with a monetary policy rate for base money of a well

defined maturity period that is transparently announced and that serves as a target for achievement through open market operations, to be conducted on a daily basis, having regard to autonomous shifts in the demand for and supply of base money.

29. This should replace the practice of announcing in advance the amount of money to be provided or withdrawn through reverse repo or repo. Indeed, it may be that the demand for liquidity surges to beyond, or falls short of, the expectation of the PBOC, resulting in unexpectedly large shifts in the price of inter-bank liquidity. It seems desirable to adopt a dynamic approach to open market operations through flexibly supplying or withdrawing base money (as in the use of SLO in the second half of December 2013) so as to stabilize its price at around the target policy rate. In the current environment, this would help to demonstrate the determination of PBOC and enhance the credibility of maintaining a stable monetary policy stance. The PBOC can continue to be as transparent in its open market operations as before, except of course that in its communications with the market, the new attitude of dynamically varying the supply of base money to cope with relative shifts in demand conditions should be made clear.

30. With a policy rate prominently established, the other interest rates applicable to the commercial banks currently determined by PBOC, including the actual repo or reverse repo rates used, would reduce in policy significance relative to the policy rate. The less transparent SLF can of course be maintained. Liquidity support facilities are of little monetary policy significance, and they should in any case be invoked at a penal rate of interest, since commercial banks are expected to manage their liquidity prudently without being dependent upon liquidity assistance from PBOC on a routine basis.

IV. The Foreign Exchange Market

31. Whether or not, and if so how, to leave the foreign exchange market to play a decisive role in the allocation of resources are delicate issues for the Mainland of China. Serious observers of the functioning of the largely unbridled global foreign exchange market, particularly in respect of whether it is efficiently serving the public good of eliminating external imbalances in a globalized economic environment, are likely to harbor a strong sense of skepticism. In my opinion, where it is expected to do so, the foreign exchange market has simply not performed the fundamental function of price (exchange rate) discovery well, given the prolonged current account imbalances that we see over the past quarter of a century. We get, instead, sharp and excessive exchange rate fluctuations and large deviations from fundamentals that destabilized the economies concerned and resulted in debilitating meltdowns of their financial systems. We get foreign exchange turnovers for currency pairs that are many, many times of what one might reasonable expect, having regard to the volume of such real economic activities as trade in goods and services, and foreign direct investment. The foreign exchange market, I am afraid, has developed to a stage where it serves more the interests of those taking huge speculative positions for short term profit and supporting the livelihoods of foreign exchange traders than the long term interests of the global economy.

(1) Convertibility

32. This is why I have earlier advised caution on the part of the Mainland of China in its efforts to move towards convertibility for the renminbi. I emphasized the need, in the relevant reform process, to ensure that the potency of the foreign exchange market is suitably harnessed so that it unequivocally serves the public interest. I also recommended that the Mainland should go for full, rather than free, convertibility for the renminbi. The distinction is subtle but actually very simple. Full convertibility of the renminbi means that conversion of renminbi against foreign currencies for all the current account and capital account items of international transactions, as defined by the International Monetary Fund, is allowed (although there can be legitimate questions asked as to why

some of the more exotic of the 40 odd items in the capital account are so helpful to the economy as to justify conversion being allowed). But this full conversion is to be operated within an efficient and user friendly foreign exchange management mechanism for application (before or after conversion) and approval (automatic or otherwise), and for the submission of relevant information to facilitate monitoring and analysis. There should also be authority legitimately to limit conversion for certain capital account items that present significant risks to monetary and financial stability, and to require the reversal of conversion if the stated purposes of the original foreign exchange transactions (for example, the purchase of renminbi for investment in A-shares within three months) are not achieved. Free convertibility, on the other hand, eschews all these foreign exchange management measures and is the type of convertibility model in practice now in the developed market economies – a model that has proven to be rather problematic.

33. This full convertibility model represents a safe approach for the Mainland of China, in accordance with the spirit of the Decisions of the Third Party Plenum, to allow the foreign exchange market to play a decisive role in resource allocation; in other words, to find a reliable price (exchange rate) that appropriately allocates resources for example between the export and import sectors and, in the process, achieve the external balance that has proven to be so elusive to many authorities. Indeed, it may not be a bad idea for individual currency jurisdictions, for the same reason, to modify their relevant policies and practices to move towards such a model, and put themselves in a better position to safeguard monetary and financial stability. While the benefits of embracing financial globalization are clear, it must be recognized that there is a lot of potent liquidity in the international financial system and the situation has been exacerbated more recently by quantitative easing by central banks of the world's major reserve currencies. Such liquidity is mostly in the hands of internationally active financial intermediaries who live on financial volatility rather than financial stability, always ready to conduct short term, possibly destabilizing and manipulative plays, paying little regard to the public interests of foreign jurisdictions.

34. I believe that the Mainland of China is well on the way to establishing this full convertibility model of foreign exchange management. Starting from a position of

having extensive exchange control measures, the process involves chiefly the relaxation rather than the imposition of controls. The PBOC, and at the operational level the State Administration of Foreign Exchange (SAFE), are encouragingly fully on top of the situation, courageously laying the foundation in 2009 for the necessary changes. I refer readers to the "Five Transformations" in the principles of foreign exchange management so clearly articulated at that time. Since then, many specific measures have been taken, in line with the spirit of the Five Transformations, for example to fast track foreign exchange conversion in respect of international trade and investment, involving the abolition of around 700 rules and regulations. There is of course scope for sequencing the liberalization process in the light of circumstances, giving priority for example to facilitating outward direct and portfolio investments.

(2) Exchange Rate Policy

35. With a safe framework of foreign exchange management in place to ensure that the supply and demand of foreign exchange reflect predominantly the needs of the economy, I also believe that the Mainland of China should feel confident enough now to allow the market even greater scope to perform its fundamental function of price (exchange rate) discovery in the best interest of the economy. We of course have seen impressive progress made already in recent years when the exchange rate, after flexibility was introduced in 2005, strengthened significantly (by a total of 25% against the US dollar up until the end of 2013) and consequently the current account surplus as a percentage of the Gross Domestic Product (GDP) reduced substantially (from 10.1% in 2007 to 2.3% in 2012). Indeed, a current account surplus, or deficit, of about 2% of GDP is accepted internationally to be a reasonable level in that it reflects a degree of structural distortion in the economy that is probably frictional in nature and is small enough to be tolerable.

36. But, for the Mainland of China, the problem is that, along with the current account surplus, there is also a substantial surplus in the (exogenous) capital account. Given the favorable differences in the growth performances and potentials of the

economies of the Mainland of China and those of the rest of the world, substantial net capital inflow arising from foreign direct investment is understandable. And in terms of foreign portfolio investment, the rest of the world seems to be substantially under-invested in China, considering the sheer economic size of China, although this is due partly to the lack of suitable investment vehicles. As capital account restrictions are further relaxed, development of capital market in China gains further traction and as the reform process in the Mainland of China commands increasing confidence of international investors, it is likely that net capital inflow arising from foreign portfolio investment will continue to be substantially positive. Indeed, after the political and policy uncertainties associated with the change of leadership have been cleared up with the successful completion of the 18th Party Congress, and as the new leadership quickly and confidently takes charge, the "twin surplus" phenomenon reappeared in the second half of 2013 and exhibited a tendency of getting bigger.

37. Thus the external imbalance, which reflects a structural imbalance within the economy involving inefficient allocation of resources, is still very much a matter of serious concern. The policy response has been one of making structural adjustments aiming to achieve a relative shift in the impetus of economic growth from exports and fixed capital formation to domestic consumption. The mixture of policies, which is now described on the Mainland as "a prescription of Chinese medicine" and which emphasizes on treating the cause of the illness rather than relieving the symptoms, is certainly correct and being enthusiastically pursued. But it is taking considerable time and, meanwhile, the external environment, characterized by aggressive quantitative easing by the developed economies, is exacerbating and prolonging the illness. It seems appropriate therefore to adopt a more dynamic approach responsively to modify the relative weights of the various elements of that prescription of Chinese medicine through relying more on the foreign exchange market to discover a market clearing exchange rate.

38. This requires SAFE to stand back more in its foreign exchange intervention activities, with a view, eventually, to intervening only to iron out wayward and erratic fluctuations, when considered necessary, for the maintenance of monetary and financial stability. There may also be a need to widen the band within which the exchange rate in

the market is allowed to fluctuate on a daily basis now, although the current 1% on either side of the morning fixing should under normal circumstances already provide enough scope for efficient price discovery and for accommodating normal market activity. For the longer term, as SAFE successfully retreats from the market and the market on its own gains further depth, such wider band, and the daily fixing, should be abandoned altogether. As experience in the developed markets demonstrates (the LIBOR and FOREX scandals), financial market price fixing by financial intermediaries can be problematic. With modern day information technology, price information on the basis of actual trades should conveniently and transparently be disseminated to serve as benchmarks for reference by market participants.

(3) Other Issues

39. The external imbalance has, in the most recent past, led to very substantial (endogenous) accumulation of foreign reserves, running at a rate of a few hundred billion US dollars a year, as the private sector understandably being rather reluctant to hold onto foreign exchange, given the appreciating trend of the renminbi. As at the end of 2013, the amount of foreign reserves has grown to US$3.82 trillion, compared with US$3.31 trillion at the end of 2012. Particularly for developing economies, the holding of substantial foreign reserves can be considered confidence-enhancing, given the impression of the availability of substantial ammunition in coping with shocks to the economy. But too much of anything is always a problem. The associated distortion in the economic structure and the inefficient allocation of resources are of course costly, there are also the exchange rate and credit risks incurred in the management of foreign reserves that could be very large.

40. With an appreciating exchange rate, the foreign reserves are falling in value in terms of the domestic currency. With the amount of foreign reserves averaging US$3.5 trillion in 2013, the “loss” of the Mainland of China, arising from the 3% appreciation of the renminbi during the year against the US dollar, amounted to US$105 billion. Prudent and proactive investment management of the foreign reserves can, of course, alleviate the

effect of such loss, but this must be proving to be difficult given the current investment environment. As far as credit risks are concerned, one just have to look at the sovereign debt crisis in Europe and the near failure to increase the debt ceiling in the United States to appreciate their seriousness. Achieving external balance is thus urgent and in the national interest of China, and the foreign exchange market, with its potency suitably harnessed through administrative means, should be allowed to play a greater, and hopefully decisive, role.

41. In this connection, the internationalization of the renminbi, and specifically its greater use in international trade and investment, should also be hastened. Elsewhere I have demonstrated that, even if the current account surplus persists, such use will reduce the extent of foreign reserve accumulation. Other things being equal, and to the extent that the renminbi is used for trade settlement, the increase in external assets of the Mainland of China as a whole arising from the current account surplus will take the form of renminbi claims of the private sector on foreign entities (such as renminbi bank loans to foreign importers) instead of foreign reserves held by the public sector. Exchange rate risks for that part of external assets will be eliminated and there will be a diversification of credit risks.

42. One remaining issue to be addressed is perhaps the merits or otherwise of using such “price adjustment measures” as the Tobin tax, zero rating the interest paid on bank reserves and raising foreign exchange transaction fees to discourage short-term speculative capital inflow that aims to take advantage of the positive interest carry and the appreciating trend of the exchange rate. Raising transactions costs to curb speculative demand is a legitimate measure to take in market regulation, but it risks introducing distortions to the price discovery and resource allocation functions of the market. However, if a targeted approach not of general application can be designed, it can of course be considered. Perhaps the foreign exchange management procedures of the full convertibility model can be differently structured for capital account items that present risks to monetary and financial stability, allowing much closer monitoring of activities and possibly requiring pre-approval or conditional approval for conversion.

V. Summary

43. In respect of the Mainland's new initiative decided at the Third Party Plenum in November 2013 to allow the market to play a decisive role in the allocation of resources, I have offered the following advice in this paper.

(a) Generally speaking, markets are superior to bureaucrats in discovering market clearing prices that facilitate the efficient allocation of resources. But the textbook, perfectly competitive markets that are most efficient in the allocation of resources are hard to come by, if they exist at all, because many of the underlying assumptions do not hold true in the real world.

(b) Thus, markets are not always in a form that is efficient in the allocation of resources and they do occasionally fail; when these situations occur the relevant authorities need to be involved in protecting the public interest through participation or intervention in markets.

(c) Such bureaucratic authority over markets should, as far as practicable, be transparently prescribed to enhance policy credibility and prevent abuse.

(d) For the Mainland of China, where public ownership is the main body of the political economy, there is a need to build a suitable motivational foundation to promote market-type behavior in economic entities that are in public ownership, through for example a separation of ownership and management.

(e) The attitude of the financial authorities towards financial markets and the financial intermediaries needs to be cognizant of the fundamental conflict between the private interests of the financial intermediaries in maximizing profits and bonuses and the public interest of ensuring the efficient mobilization of financial resources.

44. Specifically, in respect of the money and foreign exchange markets, I have made the following recommendations in this paper.

(a) Although there is an essential need for the central bank to be involved in the money market denominated in the domestic currency as a matter of monetary policy, there is considerable scope for the PBOC to step back from the renminbi money market and to focus only in controlling the supply or price of base money, so that the wider money market can be relied upon to play a decisive role in the allocation of funds in the economy.

(b) Controlling the supply of base money and, through a reserve requirement, targeting the money supply in the economy, is no longer an effective means of conducting monetary policy. The PBOC should do away with a money supply target and focus on controlling the price of base money and, through it, exert influence on the price of money generally in the economy.

(c) This change would make the reserve requirement, which in effect is a substantial tax on the banking system on the Mainland of China, redundant, and provide an opportunity over a period of time for the RRR to be phased out, thus significantly enhancing the efficiency in the allocation of funds in the banking system.

(d) Focusing on controlling the price of base money in the conduct of monetary policy means that the PBOC should, as indeed this is the stated intention, cease to play a role in the determination of interest rates that fall within the scope of business between the banks and their customers.

(e) Specifically, the PBOC should forthwith abolish its benchmark lending rates, which are largely redundant now. The PBOC should also confidently implement a program for the liberalization of deposit interest rates that it determines, starting, on the size dimension, from wholesale to retail deposits, and, on the maturity dimension, from long term to short term deposits, coordinating the timing of the liberalization of interest rates for short-term retail deposits with the introduction of deposit insurance.

(f) The PBOC should determine and prominently publicize a monetary policy target rate for short term money of a well defined maturity in the interbank market, against which it would daily, or as often as it takes, dynamically conduct open market operations to achieve. Thus, for example, when the interest rate in the interbank market of that maturity is higher than the target rate, the PBOC would conduct reverse repos and supply base money for as much as it takes to keep that interbank interest rate near the target rate. This would produce a much more stable interest rate environment to facilitate the efficient allocation of funds in the economy.

(g) All other interest rates that the PBOC determines from time to time, including the set of lending rates applicable to PBOC lending to banks and, depending on the progress in the phasing out of the reserve requirement, the interest rate paid on reserves and excess reserves, should eventually be abolished.

(h) For interest rates charged in special liquidity assistance in the form of last resort lending, such as those through the SLF, they should either be transparently priced at a pre-determined premium over the monetary policy target rate or at the pleasure of the PBOC, having regard to specific prudential considerations concerning the borrower, and kept confidential.

(i) The reliability of the foreign exchange market in the efficient allocation of resources on the international dimension to eliminate external imbalances is, on the basis of international experience, doubtful. Instead, with free flow of capital, the foreign exchange market has attained a degree of potency that could be so destabilizing as to lead to financial meltdowns in developing economies. To harness the potency of the foreign exchange market, the Mainland of China should go for full convertibility for the renminbi, supported by a foreign exchange management mechanism that is efficient and user friendly, and with reserve powers over conversion to be exercised when necessary to ensure monetary and financial stability. It is quite risky to go for unbridled, free convertibility for the renminbi.

(j) With the full convertibility model to ensure that the supply and demand of foreign exchange reflect predominantly the needs of the economy, the foreign exchange market should be allowed a greater scope than now to perform its fundamental functions of price (exchange rate) discovery and the allocation of funds on the international dimension in the best interest of the economy. This would allow the "twin surplus" to be eliminated more quickly and stem the further accumulation of foreign assets (official foreign reserves and private sector foreign assets) that are depreciating in value when measured against the renminbi.

(k) Specifically, SAFE should stand back more in its foreign exchange intervention activities, with a view, eventually, to intervening only to iron out wayward and erratic fluctuations, when considered necessary, for the maintenance of monetary and financial stability.

(l) The current band within which the exchange rate in the market is allowed to fluctuate daily should be widened to facilitate price discovery by the foreign exchange market; and, in the fullness of time, the band should be abolished altogether, along with the mechanism for the daily fixing of the exchange rate.

(m) The pace of internationalization of the renminbi should be hastened, if only for the purpose of managing the exchange and (concentrated) credit risks incurred in the holding of a huge, possibly excessive, amount of foreign reserves.