Role of China in International Finance

by

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Introduction

1. Exactly two years ago on 15 September 2008, it was a Monday and a public holiday both in Japan, where it was a day for respecting senior citizens, and in Hong Kong, where it was the Mid Autumn Festival. So, Asia was relatively quiet on that day, with Hong Kong in fine weather, expecting to welcome a clear, full moon in the evening with the many traditional, colorful lanterns out for the occasion. Like many other hard working professionals in finance, I was equipped, as usual, with my Blackberry and my separate mobile phone during the long weekend. Both rang at the same time, and e-mails and messages rushed in, I recalled. The subject matter of those calls and messages was likely to have serious implications for our markets the next day – the collapse of Lehman, the merger of Merrill Lynch with Bank of America and the rescue of AIG, all happening at the same time.

Paradigm Shift

2. You know the rest of the story, I imagine much better than I do, as you are much closer to the epicentre. From afar, in Hong Kong, the events, or rather the three different approaches in the handling of the three financial institutions, were quite surprising, particularly when the events surrounding Bear Stearns had, a few months ago, sent what I thought were clear messages on the dangers of systemic failure in finance. Indeed, as we in Hong Kong learnt in the Asian financial crisis of 1997-98, when financial markets threaten to fail, there is a clear need for the authorities to act decisively, if necessary to underwrite the solvency of the financial system, moral hazard notwithstanding, and pre-empt a debilitating financial meltdown.

3. Perhaps the political environment and the legal framework then in the United States did not allow the authorities to take such decisive, interventionist action. Indeed, in developed jurisdictions where capitalism and the free market had been taken for granted as the pre-conditions for sustainable growth and development, there had always been strong institutional resistance to government intervention. Market intervention of the type we conducted in Hong Kong in 1998 to correct market failure and fight off market manipulation was, I remember vividly, quite readily condemned, even by those with a responsibility for financial stability. But on this occasion the supremacy of the Anglo-Saxon model of economic development has been seriously challenged. The events of 2008-09 are seen by many as proof that the market system is destined to crisis, for it is susceptible to being rigged, reflecting what they see as capitalism's intrinsic evil.

4. Where serious failure occurred in the financial system, governments had no alternative but to provide extensive support, through buying assets from and guaranteeing liabilities of the financial institutions, and providing liquidity and capital. We saw governments also getting involved in the operation of financial institutions, by giving to banks that have received injections of public money policy directions on lending and determining the remuneration of bank management. In July this year, the European Union passed new rules restricting bankers' bonuses, while the US earlier issued similar guidelines.

5. Of course, some of the support measures are only temporary in nature, aimed at lessening the adverse impact of the financial crisis on the economy and facilitating financial repair, but I cannot help noticing the similarities of many of these measures with certain standing practices in the financial system of China. There you have a development model, described as a socialist market economy, proving to be a great success generally, and specifically in terms of ensuring that the financial system operates in support of the economy to promote sustainable growth and development, and in terms of pre-empting the occurrence of financial crises. I would not go as far as to say that there has definitely been a paradigm shift in development economics from a capitalist free market economic model towards a socialist market economic model, or state capitalism as some have chosen to describe it. But I think China's experience has a lot to offer when it comes to exploring the appropriate degree and form of government involvement in the financial system that is conducive to delivering financial stability on a sustainable basis,

just as the experience of the developed markets in embracing market freedom is valuable in promoting financial efficiency.

Conflict of Interest

6. In whatever action to be taken to repair and reform the financial system, all concerned should recognize that realistically there is, particularly in the short term, a conflict between the private interest on the part of the financial intermediaries to maximize profits and the public interest pursued by the financial authorities to ensure financial stability and promote financial efficiency. Put simply, and some of you may not be happy to hear this, the bigger the profits and the bonuses for the financial intermediaries, which de facto means a larger intermediation spread, the less efficient is the financial system in financial intermediation. With the middle man taking quite a big cut, the rate of return for investors must necessarily be lower and the cost of funds for the borrowers higher than would otherwise be the case.

7. But, interestingly, we saw in the pre-crisis period an anomaly: financial intermediaries were making record profits and getting astronomical bonuses while concurrently the intermediation spread seemed to be narrowing, with investors getting high returns and borrowers, including those who are not credit worthy, acquiring cheap funding. The intermediaries attributed this to financial innovation that they so cleverly put together, thus justifying their attractive remuneration. But we now know that this anomaly observed at time t, that is, in the pre-crisis period, was made possible at the expense of a serious erosion in the structural robustness of the financial system and the consequential sharp widening of the intermediation spread at time t+1 as the financial crisis broke. In other words, the highly remunerated financial innovation did not lead to any permanent improvement in financial efficiency. Instead, it led to an inter-temporal shift in the intermediation spread. As the crisis broke, investors were hit badly, losing a lot of money, erasing those that they had made in the pre-crisis period, and possibly more; and the cost of funds for the fund raisers moved sharply higher, that is, if funds were available at all.

8. Clearly, in the pre-crisis period in the developed markets, the private interests of the financial intermediaries were allowed to override the public interest. Financial innovation was welcomed by the financial authorities and the proclaimed benefits seldom challenged. Finance was able then to attain a life of its own, taking on features that one would find rather difficult to relate to the basic function of finance, which is financial intermediation. Finance also gained a degree of potency that turned out to be quite destructive. With globalization and advanced information technology, the destructive forces worked across all borders, whether they were defined by geography, currency, financial institutions, financial markets or financial instruments. And the destructive forces worked with considerable speed, much faster than the speed at which national regulators could work together on an international dimension to harness the potency of international finance.

9. Interestingly, in China, that conflict between the private and public interests has not been much of an issue. With the degree of public sector ownership in financial institutions in China being relatively high, the longer term public interest thankfully is given greater attention in the general functioning of the financial system. The authorities have also been rather pro-active in identifying systemic risks and issuing directives to financial institutions that go a long way to pre-empting those risks from materializing. This, and the need for specific approval for the introduction of new financial practices, moral hazard notwithstanding, meant that there is an effective mechanism for supervisory oversight in innovative financial activities. Incidentally, this macro-prudential approach to regulation has become a subject matter of increasing interest among financial authorities worldwide after the financial crisis broke. It is, for example, an important item on the agenda of the Financial Stability Board. China has been practicing this approach for a long time and doing so effectively. There is therefore useful experience to be shared. Notice the timely and strong measures taken this year to curb property speculation through, among other things, restraints in bank credit. Notice also the move by all the big banks, presumably with approval and possibly encouragement from the banking supervisor and the largest shareholder, to raise additional capital this year, as the economy recovered, which is an interesting example of how the macro-prudential approach could work to limit pro-cyclicality.

Stronger Voice

10. And it is in China's interest to share that experience with others, given the increasingly contagious nature of financial crises under globalization. The maintenance of financial stability is no longer a domestic issue but very much a global effort. We are all aware of the growing importance of China in the global economy, in international trade and, even more so, in international finance, being by far the largest foreign reserve holder in the world. China should therefore have its rightful place in the international financial institutions and forums with responsibility for reforming the international financial architecture. China should have its rightful involvement in the standard-setting bodies looking at international financial issues. I am glad to observe generally greater efforts to engage China in recent years, but in many areas, such as voting rights in the International Monetary Fund and in other major international financial institutions, China's representation is still disproportionately low, however one measures it. It is not in the interest of promoting a safe and efficient international financial system to limit China's ability to contribute to this important task.

Global Imbalance

11. Let me turn to China's role in addressing the global imbalance. When this crisis broke, there were some who attributed it to the global imbalance, specifically to the large trade surplus that China has been running, through keeping its currency, the renminbi, undervalued to gain unfair trading advantage. They thought that this was a more important reason for the crisis than, for example, the faulty model of credit risk transfer through securitization that encouraged a serious erosion of credit standards and a proliferation of toxic financial assets. I am sure there were political considerations behind this rather strange view. It was, in fact, in the interest of promoting financial stability, of course in China but importantly also in the Asian region, that China adopted the special exchange rate policy of fixing the renminbi against the US dollar from July 2008 to June 2010. Had this not been done, I am quite sure that the exchange rates of the Asian currencies would have gyrated perhaps even more sharply than the exchange rates among the currencies of developed markets during that period, which may have the effect of seriously undermining financial stability in the Asian region.

12. In any case, empirical evidence shows that the balance of trade of China is at best insensitive to movements in the exchange rate and possibly bears an inverse relationship with it. In other words, an appreciation of the exchange rate may possibly increase the balance of trade surplus rather than decrease it. I am sure those familiar with the economic theory behind this subject understand this counter-intuitive possibility, remembering of course that the mathematical form of that relationship is specific to a particular economy and dependent upon the price elasticity of imports and exports of that economy. Indeed, in the two years when the exchange rate of the renminbi was held stable against the US dollar, the balance of trade of China fell sharply, although other things have not been equal, in that the income effect on trade, at a time of economic downturn in the major exports market of China, may have been at work too.

13. But it is necessary to address the persistent trade surplus of China in recent times, which had necessitated rapid accumulation of foreign reserves, given capital account controls, and correspondingly large injections of base money that has to be sterilized to pre-empt excessive credit creation and the inflationary consequences. This is particularly so when, as China has successfully dealt with the negative impact of the financial crisis, there is no longer a need to provide too much liquidity to the banking system and no need for banks to lend pro-actively when the economy is no longer under stress. There is also the need, in order to sustain growth in the longer term, to engineer a relative shift away from the highly export dependent economic structure to one that relies also on domestic demand. I believe that these are the important considerations for China in tackling its external imbalance and not the highly politicized bilateral trade deficit that the US runs with China, although if China is successful in expanding domestic demand, it would go some way to correcting this global imbalance that has been the focus of many.

14. I am aware of the strong desire in the leadership in China to address this matter, but I am not privy to the strategy being discussed or adopted. As an observer, and having regard to the need on the part of China to pursue other desirable macroeconomic and monetary objectives at the same time, I think the solution lies in making available a stable and higher, risk-adjusted rate of return for the very high savings of the people. Together with significant enhancements to social security, this would reduce the desire to self insure through saving a large proportion of household income, as is the case now, and increase the propensity to consume, thereby, other things being equal, increase imports.

There is a need therefore to continue to develop the domestic financial markets to provide diversified financial instruments to satisfy the risk appetite of domestic savings. At the same time, given the significant current account surplus, the conditions are ripe for further capital account liberalization, so that domestic savings could also be mobilized offshore, in Hong Kong for example, or through Hong Kong, where there is a wide spectrum of financial and other assets that offers a stable and higher risk-adjusted rate of return.

15. Insofar as the exchange rate of the renminbi is concerned, because the trade balance is insensitive to exchange rate changes, it should simply not be used as the policy instrument for addressing the external imbalance. But as China further embraces globalization and its rather low price level converges with those of its trading partners, there is the inevitable need for the real effective exchange rate to appreciate over the longer term. Whether this should take the form of an inflation rate that is significantly higher than those in its trading partners or an appreciation of the nominal exchange rate, measured against a basket of currencies and not just the US dollar, is a matter of choice for China. Considering the relative risks of these two alternatives, I think the policy choice is clear. I believe that this is how the matter of the exchange rate should be looked at. With the re-introduction of flexibility to the exchange rate in June this year, I believe that a long term trend of appreciation against the basket of currencies, as was the case during the July 2005 to July 2008 period, will be re-established. But there will certainly be fluctuations around that trend in the short term, and certainly fluctuations in the exchange rate against the US dollar, as prevailing domestic and international financial and economic conditions exert their influences.

The International Monetary System

16. Let me turn to China's role in the international monetary system. Frankly, I do not feel comfortable about the international monetary system as it looks now. It is resting on two pillars – the US dollar and the euro. By virtue of the fact that they are the domestic currencies of the two largest economic areas in the world, they are rather naturally serving the role as international money – mediums of payments, for the store of wealth and as units of accounting. For the international monetary system to function

properly, it is necessary for the (whatever number of) pillars it has to command the confidence of those using it. While accepting that the economic and political weights of the two jurisdictions matter to a considerable extent, confidence in a currency is ultimately dependent on the economic fundamentals being sound. The Asian financial crisis is a very good example of how confidence in a currency can quickly breakdown when less than prudent macroeconomic policies are being pursued. In fact, then, even the currencies of those jurisdictions that had robust records of macroeconomic management were subject to pressure. Free and open financial markets do have a sometimes unpredictable way of exerting macroeconomic discipline on individual jurisdictions.

17. I do not wish to exaggerate the problems that the United States and the euro area face or belittle the tremendous efforts being exerted by the authorities to address the problems they currently face. But if one surveys the relevant macroeconomic numbers, not just of the current situation but also those making up the recent historical trends, one sees a worrying combination of large deficits, public debt, unemployment and structural problems. These macroeconomic numbers could have easily sent a smaller jurisdiction into financial chaos and its currency into a tailspin. There are, of course, no meaningful alternative international currencies at present to facilitate the management of the ever growing volume of foreign reserves held by other jurisdictions, or the payment and settlement of the increasing volume of international transactions in the globalised environment. But I am sure many would much prefer the two currencies to be supported by sounder economic fundamentals or there to be other alternatives. In short, therefore, the international monetary system has been resting on two pillars that are perhaps less robust than they ought to be, given their important role.

18. Adding to my worries is the huge amount of liquidity in that system, now and in the foreseeable future, the product of quantitative easing or credit easing that may stay a while. With interest rates at very low levels, this liquidity is desperate for some return, ready to go for, or imaginatively create, opportunities for profit in global financial markets. It is being mobilized by financial institutions that have survived the financial crisis and are, regrettably, slipping back quickly into old habits while financial authorities are taking time to agree on the much needed reform in financial regulation. I consider this scenario to be highly conducive to producing sharp volatility in global money and foreign exchange markets, exacerbating the considerable weight that the two wobbly

pillars of the international monetary system have to carry.

19. Perhaps it is prudent to just think ahead and explore how the international monetary system should be strengthened, in particular made structurally more stable, even if you are not as worried as I am about it. Indeed, there have been realistic suggestions for a tripod model to be established for the international monetary system through the creation of a meaningful third pillar, either in the form of a supranational currency or a sovereign currency. An obvious supranational candidate for this third pillar is of course the SDR. Whether or not it is possible to achieve international consensus on this is doubtful, given the many complex political considerations this would involve. Even with consensus, the serious international efforts demanded of both the official and private sectors to activate the SDR for application in a wide range of international payments may not be forthcoming. But I would not dismiss this possibility without seeing proper research from authoritative sources, such as the IMF, who ought really to have a position on this, even if it is one saying that the international monetary system does not need fixing. Interestingly, the IMF seems now to think that there is a need to include the renminbi in the SDR.

20. Another supranational candidate to be the third leg is a new regional currency somewhat like the euro. One region that looks well qualified, in terms of economic and financial strength, to have such a currency created is I think Asia. But, there are difficult, if not insurmountable, political and structural issues to be addressed, learning from the experience of the euro. Asia is furthermore rather more heterogeneous in many ways and geographically fragmented than Europe, such that currency union in Asia is not something that any of the jurisdictions comprising Asia look at with enthusiasm. But, again, I would not dismiss this possibility lightly, for, notwithstanding coping well with the financial crisis of 2008-09, individual jurisdictions in Asia remain vulnerable to the potency of international finance. This is particularly so for those with free and open markets, and are of a size that is big enough to have liquidity to attract international capital but small enough to be tossed around. But I am not optimistic that this will get on to the agenda for regional cooperation in Asia.

21. And so the market may, on its own, turn a sovereign currency into the third pillar for the international monetary system. This could come in the fullness of time as a

result of gradual shifts in the preferences of those having a need for more stable and less risky alternatives for making international payments and holding foreign assets. But I see no currency that can quickly assume that role. For the longer term, however, I think there is one candidate. Before naming it, I should perhaps briefly identify the pre-requisites. I see five of these. First is for the economy of that currency, specifically the volume of international transactions between that economy and the rest of the world, to be sizable. Second is for that currency to be supported by the sound macroeconomic fundamentals necessary for the maintenance of currency stability and international confidence. Third is for the currency to be freely and conveniently convertible, at least for the legitimate purposes for which it is to be used, to facilitate its wide international use as a medium of transaction, store of wealth and a unit of accounting. Fourth is for the financial system of that currency to be of considerable depth and diversity comfortably to support financial intermediation on an international dimension denominated in that currency. Fifth is for the financial infrastructure – the payment, settlement, clearing and custodian systems – supporting transactions denominated in that currency to be robust and efficient.

22. If the renminbi stays on its long term appreciating trend and the economy of China continues to grow at a sustainable and reasonably fast pace, the size of the economy of China should, in about twenty years, be close to or even surpass those of the United States or the euro area. The successful track record of macroeconomic management in China is for all to see, even though not all agree, understand or appreciate the way how a socialist market economy is run. One can of course be critical of the efficiency in the allocation of scarce resources, but no one can doubt the high efficiency of the policy transmission mechanism, made possible by the readiness of micro level decisions to follow guidance or direction from the State. The ability to maintain currency stability is therefore not in doubt, which augurs well for the building of international confidence in the renminbi. Indeed, this is high and the investment demand for the renminbi is keen. So the renminbi is on track to satisfy the first two pre-requisites to be the third leg of the international monetary system. But there is still some distance to go and many reform measures to be undertaken before the other three pre-requisites are satisfied, namely, free convertibility, financial system capacity and financial infrastructure robustness.

23. It is in the interest of enhancing the structural stability of the international

monetary system that China should move quickly in these areas. Indeed, it is also in the domestic interests of China – financial efficiency, sustainable growth and development, maintenance of the value of sovereign wealth, etc – to move quickly in these areas. The question, as always, is how to do so while prudently managing the associated risks, which can be quite challenging, having regard to the potency of international finance, as demonstrated by the frequent occurrence of financial crises over the past twenty years.

24. But I think China has the wherewithal to take on the challenge. There is obviously the financial clout, including being the largest foreign reserves holder in the world, and the effectiveness of policy making in China. Further, there is, strategically, the capitalist, free market economy of Hong Kong as integral part of the country under "one country, two systems", serving as the testing ground for financial reform and liberalization of the Mainland. Through the establishment of an off-shore renminbi market there, Hong Kong is ideal for promoting the internationalization of the renminbi. Considerable progress has been made in developing renminbi business in Hong Kong, starting with the taking of renminbi deposits, the issue of renminbi bonds and the use of the renminbi for trade settlement. Separately, domestic currency swap arrangements have been entered into between China and many of its trading partners to enhance the availability of the renminbi outside of the Mainland of China. Two months ago, another strategic move was taken. This amounts to allowing the off-shore renminbi market in Hong Kong to do its own things in its own ways with renminbi business, in much the same way as it conducts businesses denominated in other foreign currencies.

25. The potential for further development is enormous, given keen and increasing overseas interest at the official level in ensuring that their financial systems are plugged into the renminbi market and at the business level for the attractive choice of using the renminbi for transactions and perhaps for storing wealth. There is, for example, no restriction in the use of the renminbi for equity trading in Hong Kong; and I am sure this will come soon. Foreign investors wishing to have an investment exposure to China through the Hong Kong market would obviously want to be exposed to the renminbi as well, not that exposure to the Hong Kong dollar is of any concern, given the long history of firm linkage with the US dollar through robust currency board arrangements. And many exporters selling goods to China would like to be paid in the renminbi as well, just as importers from China would want to manage exchange rate risks by paying renminbi

instead of foreign currencies. And there will I am sure be financial instruments denominated in the renminbi for holders of renminbi funds to park their funds profitably.

26. And the risks that the off-shore renminbi market may pose to the on-shore market are manageable. The infrastructure for doing so is already there, in the form of a formal payment and settlement linkage between the two markets, with the renminbi settlement bank in Hong Kong operating a renminbi settlement account with the People's Bank of China, the central bank. Risk management restrictions are laid down as conditions for the provision of settlement services by the People's Bank of China to the renminbi settlement bank in Hong Kong and, by extension, to all the licensed banks in Hong Kong that are participating in renminbi business. These conditions are, understandably, restrictive in certain areas of activity, for example, those relating to the arrangements for the off-shore market to cover net long or short renminbi against foreign currency positions with the on-shore market. There is also the need for prudential requirements and limits. But I do not see these as inhibiting the healthy development of the off-shore renminbi market in Hong Kong and its use for internationalizing the renminbi.

27. Clearly, developing China's financial system to allow the involvement of overseas investors and fund raisers is also important for the internationalization of the RMB. For as long as there are capital controls, direct access is difficult. Here again, Hong Kong plays an important role in providing the bridge for the predominantly domestic financial system on the Mainland with the rest of the world. Indeed, much of the financial intermediation between the Mainland and the rest of the world is now conducted in Hong Kong, enabling investors and fund raisers from the Mainland to interact with their counterparts overseas. Hitherto, however, the domestic market in various cities on the Mainland and the international market in Hong Kong, for the same financial products where they have a common presence, are structurally separate, in the sense that the two markets are not fungible and so prices of the same products in the two markets can differ significantly. I believe that making the two markets interactive to allow the domestic forces of supply and demand to interact with the international forces of supply and demand would greatly enhance market efficiency, in terms of price discovery, depth and liquidity. I am confident that the product of making the two markets interactive will be a market that is much bigger than the sum of the two separate markets,

as it will attract many more market participants domestically and overseas. This is I think key to accelerating the pace of internationalization of China's financial markets and correspondingly accelerating the internationalization of the renminbi.

28. Whether or not in the end the renminbi will assume the status of an international currency, a reserve currency and the third pillar of the international monetary system is of course for the market to decide. China is cautiously making the right moves, in its own interest and in the interest of contributing to making the international monetary system more stable. I look forward very much to further developments in the internationalization of the renminbi through the use of the off-shore renminbi in Hong Kong, and for the renminbi to play an important role in international finance.