Delivering Financial Stability in China

By

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

Working Paper No. 8

April 2012

Institute of Global Economics and Finance
The Chinese University of Hong Kong
13/F, Cheng Yu Tung Building, 12 Chak Cheung Street, Shatin, Hong Kong

Delivering Financial Stability in China

(Contribution to IMF Book on *"China: Emerging Challenges to Financial Stability: Some Issues for Policy Makers"*)

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

Executive Vice President, China Society for Finance and Banking
The People's Bank of China

Distinguished Research Fellow, Institute of Global Economics and Finance
The Chinese University of Hong Kong

Chairman, Macroprudential Consultancy Limited

When commenting on financial reform in China, Premier Wen Jiabao has often emphasized the philosophy of "gradualism, controllability and the ability to take the initiative". Like many other sound bites of leaders in China, this philosophy has become much of a slogan, to the extent that the underlying important messages have become fuzzy with the passage of time. Against the continued international chorus of politically inspired calls for financial liberalization, for example, freeing up the exchange rate and the opening up of the capital account, it seems necessary to re-emphasize the philosophy in any professional discussion on financial reform in China.

The risk of departure from his philosophy of financial reform for China is, of course, financial instability, which, in light of the experience gained from the two severe financial crises of the last two decades, can be debilitating, to emerging as well as developed economies. With globalization and an abundance of liquidity, financial markets have become rather potent, able to rack havoc to open economies, big or small, sometimes indiscriminately, playing on the slightest of aberrations in public policies in an almost predatory manner, and justifying such action as a manifestation of valuable market discipline in a free market environment.

There is little doubt that market freedom in finance ensures the efficient allocation of financial resources. In the socialist market economy of China, where the involvement of the state in finance is high relative to other, particularly developed capitalist jurisdictions, the case for allowing the market to play a bigger and freer role in finance is clear. But, in moving towards this direction, China needs always to remind itself of the theoretical assumptions behind the efficient market and be alert to the possibility that, in the real world, these assumptions do not always hold true. In finance, we have observed time and again that Adam Smith's invisible hand cannot always be relied upon to transmute individual acts of selfishness into desirable collective outcomes for all. In finance in the real world, there are factors limiting the mobility of the invisible hand. They include information problems, herding behavior, market imperfection such as monopoly or oligopoly power, market globalization while regulation remains domestic, incentive distortions, derivative products or the tail that wags the dog, greed, fear, stupidity, criminality, leverage, speculative bubbles, irrational exuberance, uncertainty, manipulative and predatory behavior, policy blunders, political influence of self-interested groups, etc.

An important function of the market is price discovery. It is precisely in this important function that financial markets have exhibited repeated tendencies to fail. Greed and manipulative behavior often produce volatility in financial markets that is so sharp as to undermine the viability of financial institutions and therefore stability of the financial system. In the major foreign exchange markets, for example, only less than 5% of turnover is represented by the foreign exchange needs arising from real economic activity, such as trade and foreign direct investment, with the other more than 95% represented by position taking, largely of a speculative nature but presented as necessary market making to provide liquidity. But instead of accurate price discovery to facilitate those important real economic activities, there is sharp volatility and frequent exchange rate overshooting instead, undermining financial stability. One can clearly question the need for the over 95% of turnover unrelated to real economic activity, other than serving to provide employment for the large number of well remunerated foreign exchange traders and the (unsustainable) profits they make for the financial institutions in which they work.

Thus it is necessary, in China as well as in other jurisdictions, in reforming the regulatory framework for the financial system, to place great emphasis in arrangements that allow the potency of financial markets to be harnessed in the public interest, delivering stability, integrity, diversity and efficiency in the financial intermediation that is so important for promoting economic growth and development. If this involves, for example on renminbi convertibility, a mechanism for seeking and giving approvals, and for providing information for activities to be appropriately monitored, China should not shy away from it, simply because it is not the norm for most of the rest of the world. For the latter, the reform agenda, against the background of the ongoing financial crisis, is also a matter of harnessing the potency of financial markets, which have caused chaos with market freedom, through tighter regulation. There is ground in between to be explored.

Another philosophical issue that China, as well as other jurisdictions, should recognize in financial reform is the inherent conflict between the private interests of financial intermediaries in maximizing profits and bonuses on the one hand and the public interest of efficient financial intermediation on the other hand. Put simply, the greater the profits and bonuses of the financial intermediaries (the higher the intermediation cost) the lower the efficiency of financial intermediation, with investors and depositors getting a lower rate of return and the fund raisers incurring a higher cost of money. Naturally, the financial intermediaries seek to manage, or rather hide, this conflict through innovative arrangements that, at least for a while, promises higher rates of investment return and lower costs of funds, even to those that are not creditworthy – financial innovation that enhances financial efficiency – and for that they became even more highly remunerated.

It would be difficult to argue that financial innovation does not enhance financial efficiency. Credit risk transfer through securitization enhances financial efficiency, until it creates the incentive in the financial system that eroded credit standards. When that happens, financial innovation becomes a form of inter-temporal transfer of the intermediation spread from the future (widening of the spread) to the present (narrowing of the spread) that gives the impression of increasing financial efficiency alongside (the contradictory) rising profitability of the financial intermediaries. Unfamiliar risks to financial stability build up in the process and culminate in financial crises that are inevitably manifested in a sharp widening of the intermediation spread, in which investors find themselves losing money and fund raisers not being able to raise funds.

Thus, for China, which still has a rather rudimentary financial system, there is a need for great caution when it embraces financial innovation as a means to enhance much needed financial efficiency. Those in the financial industry would argue that it is not for bureaucrats to try and out-smart financial markets in, for example, pre-determining the boundaries for financial innovation by administrative means. But, at a time when the financial systems of developed markets are struggling to go back to basics, a pro-active involvement of the financial authorities in China in assessing the risks associated with innovative financial arrangements and ensuring that prudent risk management mechanisms, both within financial institutions and in the financial system as a whole, are a pre-condition to their introduction is well justified.

Financial authorities should simply say no to financial proposals that they find difficult to understand, notwithstanding whatever good track record or sound theoretical arguments presented in support of these proposals. If the financial authorities in the United States were courageous enough to say no to sub-prime mortgages and insist on the securitization of mortgages with conservative loan to value ratios only, the ongoing financial crisis of the century could well have been avoided. In the same vein, financial authorities should also just say no to financial arrangements that, in their opinion and having regard to domestic circumstances, do nothing to promote the fundamental function of financial intermediation, even though they are quite fashionable in other financial systems. “Others have it” is never a good enough reason for the introduction of innovative financial products – witness the damage to the global financial system caused by Collateralize Debt Obligations and Credit Default Swaps.

In this connection, China should be alert to the political reality that financial intermediaries, given that they control where money comes from and where it goes, have a strong political lobby, a phenomenon that is perhaps more pronounced in the developed markets in Europe and America than in China. This has led, in the developed markets, to inadequate powers and tools in their legal frameworks for financial authorities to exercise prudential supervision of financial institutions and the regulation of financial market behavior. Within the framework of the socialist, market economy of China, this seems less of a problem. Furthermore, the policy transmission mechanism in China seems a lot more efficient in terms of producing desirable results. But, as China progresses further on its path of financial reform and liberalization, it is inevitable that some of the levers currently available, effective as they may be, will be lost, thus eroding China's ability to deliver financial stability. It is not easy to strike the right balance in this delicate development. A strategy may be to retain many of the powers and tools that are considered essential, but to enhance transparency and accountability in exercising them by the financial authorities. With globalization and an abundance of international liquidity, financial liberalization is a risky process and it would be prudent for China to keep, as much as possible, the financial armory that has served China so well in the past.

For the financial authorities to deliver financial stability in the complex external and domestic environment confronting China is clearly a challenging task. There is a need for the right incentive system to attract the necessary talents from the financial industry, which is increasingly run on a commercial basis and given autonomy in the determination of remuneration for its employees, and from overseas. This is an issue that extends to the much wider dimension concerning the incentive system in the labor market of the socialist market economy of China. There has, nevertheless, been some labor mobility between the financial regulators and the financial industry, but this is less market oriented than desired. The preference is for financial talents to move from the public sector to the private sector and for the reverse, particularly at the senior levels, to be mandated by the State, an arrangement that arguably undermines regulatory effectiveness. While this practice has, hitherto, not led to any apparent supervisory or regulatory failings of a systemic dimension, there is doubt as to whether the current arrangement will continue to be as effective as it has been, as finance in China gains in sophistication. It seems desirable for the financial authorities to be given financial autonomy and for the necessary financial resources to be derived from the financial industry through appropriate financial levies.

One specific way of achieving this may be for the People's Bank of China, as the central bank, first to be given financial autonomy, allowing it to keep the profits of the issue of currency notes and charge a service fee for the management of the foreign reserves. It may be that there is significant surplus that could go towards funding part of the budgets for the three Regulatory Commissions, as a contribution of the People's Bank of China to financial stability, thus lessening the impact of levies to be charged by the three Regulatory Commissions on the financial industry.

The maintenance of financial stability is not an academic issue, hence the non-academic approach of this short paper. It is a difficult task, but it can be made easier to achieve by creating a culture amongst stake holders of the financial system that continuously remind them of the basic function of the financial system, which is to support the economy, rather than to provide a playground for making money. Many financial markets are basically zero sum games. Consistent trading profits year after year for financial institutions or traders can only be possible if they possess technical skills that are superior to others, have access to inside information and are persistently lucky. None of these hold true in the long run. Short term, unsustainable profits and bonuses allow distorted incentives to creep in, leading many to forget the purpose of their existence and behave in a manner that eventually undermines financial stability. There is a need for a cultural revolution in finance.