Financial Reform in the Middle Kingdom

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When will the People's Bank revalue the Reminbi? Will the Shanghai A share market sustain its anaemic recovery this year, or plumb new depths? Will the Bank of China and China Construction Bank float successfully in Hong Kong in 2005? Will China win more Olympic gold medals than the US in Beijing in 2008? Those are just a few of the questions I do not plan to answer directly this evening.

I do aim, however, to set at least the first three of them in context. They are all linked to progress in financial sector reform, which is my subject tonight. When he was pressed on the revaluation of the renminbi at the recent G8 meeting in London, Governor Zhou Xiaochuan's response was that "China needs more time to reform its banking and financial systems to pave the way for reforming the currency policy," (1) so that linkage is clear. And most observers would accept that concerns about the quality of corporate governance and regulation are part of the reason for the grim performance of the stock market in the last three years.

Is the Chinese financial system fit for purpose?

The focus of my remarks today is on how well China's financial system is adapted to the needs of a fast growing economy. In spite of the country's dramatic economic success, indeed perhaps even because of that success, are there underlying weaknesses in the country's financial structure, weaknesses which will need to be corrected if China is to continue on its long and so far uninterrupted growth path?

Also, a related question, is China ready to take its proper place in the global financial system? Are its financial institutions ready to compete with those from Western countries as WTO membership brings about significant further opening of the Chinese financial markets to new competitors?

To begin to answer these questions we need to step back a little. We need to look first at the shape of the Chinese financial system by comparison with those of other developed and developing countries.

The first point to note is that the Chinese system is in one sense already comparable to those of developed economies. A study published only last week by McKinsey compared the depth of financial markets by country. (2) The calculation was a simple one: total financial assets as a percentage of GDP. On that measure, China is more financially developed than the Eurozone. Chinese financial assets total 323 % of GDP; in the Eurozone the figure is 314 % GDP. India, for example, is at 137 %. And Chinese financial assets have been growing very rapidly, at 14.5 % a year over the last decade. China now accounts for 4% of the Global Financial Stock.

The figures also show, however, that China remains very heavily dependent on bank financing. 62 % of all financial assets are in banks. The Indian percentage is only 45 %, the UK is at 28% and the US at only 20 %.

If we look at the equity and bond markets the differences are even more striking. The capital value of the US market fluctuates around 150% of GDP, while in China it is 30 – 40 %, and falling in the last couple of years. The contrast in the bond market is sharper still. In the US the capital value is around 150% of GDP, while in China it is

only a quarter of GDP. Even that may overstate its economic significance, for reasons I will explain later.

In recent years China's banking system has continued to grow more rapidly than GDP. Indeed since 1992 the speed of growth of deposits in the banking system has been higher than the growth of GDP in every year. Last year, domestic bank assets grew by 13.6%, while the economy probably grew by around 9%. At the same time, while the bond and equity markets expanded in the 1990's, more recently they have fallen back, and attempts by the authorities to promote a revival of the capital markets have so far met with relatively little success.

Does this matter? After all, the Chinese economy has done very well during this period in which it has been, by international standards, over reliant on bank financing. Why should that not continue into the future?

Conventional wisdom in the international financial institutions now strongly favours the development of diverse sources of finance for developing countries. The World Bank helps countries to develop their bond markets, in particular.

In part, this enthusiasm is driven by theory. It makes sense, so the theory goes, for companies to offer a range of financial assets with different risk and return characteristics, better to match the preferences of investors. If they do so they will, other things being equal, minimise their cost of capital. Also, so it is argued, equity and bond markets are better able to mobilise capital to support projects and companies offering the most attractive returns on investment. They may do so more quickly than banks which often display evidence of a " sunk costs" mentality in their investment decisions. In other words, they are often inclined to throw good money after bad, in an attempt to rescue earlier unwise loans.

What evidence, in the specific Chinese case, can we see to support these propositions? Perhaps the most powerful piece of evidence comes from the state of the banks themselves. It is now well understood that the major commercial banks have a huge proportion of non-performing loans in their balance sheet. Different commentators offer different estimates on the scale of these bad debts, and they undoubtedly vary from bank to bank. But in spite of recent improvements external

observers such as Standard and Poors estimate that some 35% of the loans in the major Chinese banks are non-performing. (3) The official figures are rather lower, but still large at over 13%. (There are definitional differences behind these figures, as well as different degrees of optimism).

Some of the worst loans, of course, have been transferred to asset management companies which are attempting to recover a portion of the lost capital, though with mixed success so far. Standard and Poors estimate that a full bail-out of the banking system would cost $656 billion, or 43 % of estimated 2004 GDP. That is quite a lot of money, in any language.

When asked in August of last year whether the banking system is solvent, Steven Dunaway, the IMF Mission Chief to China answered simply "no". He went on, the "problems aren't solved and more efforts are going to have to be made and additional capital may need to be put in by the government." (4)

There are many reasons for this unhappy experience. It is partly a phenomenon driven by the rapid growth rate. But

it also reflects past weaknesses in credit appraisal and the impact of political influence over financing flows. Indeed, for a long time, the large Chinese banks were to be seen more as funding channels, supporting particular economic sectors, than as independent financial institutions seeking a return on capital employed. It was perhaps a mistake for the Chinese to deem them to be commercial banks when they first emerged from the chrysalis of the People's Bank, before implementing more fundamental reforms.

These problems in the banking system are of considerable economic importance. And they have consequences for the financial system as a whole. In a recent paper presented to a Harvard seminar on the Chinese financial system Bei Duogung of the Chinese International Capital Corporation said " From the angle of finance, the imperfection of the financial system, the under development of the financial market and the poorness of financial products make a lot of capital flow abroad and not into the places where it can be used effectively. In a word, in comparison with the capability of developed countries to allocate resources effectively, our country still has a long way to go". (5)

This phenomenon of capital export to other countries is quite a striking feature of the current global financial system. The shallowness of traded asset markets in Asia, has been part of the reason for the large outflows of funds from Chinese and other Asian savers into debt elsewhere. Asian countries hold roughly $2 trillion of debt in foreign exchange reserves, mostly in US dollars and in Euros. In return, overseas investors put their money into direct and equity investments in Asian countries. In a paper delivered in Beijing last year at the China Centre for Economic Research, Andrew Sheng, the Chairman of the Securities and Futures Commission of Hong Kong, characterised this exchange as follows:

"With its plentiful cheap labour and natural resources, Asia, particularly China and India, has emerged as the manufacturing and services subcontractor to the dominant economic power and leading global consumer, the US economy. In turn, Asia uses the US as its key financial centre to manage its risks and allocate back investment. The total equity return swap (where Asia holds debt in the US and in turn the US holds direct investment in Asia) pays the US financial sector roughly an 8 to 11% premium for better risk management skills, this being the difference

in return on foreign direct investment (mostly equity) of 12-15% per annum and the long term return on US Treasuries of 4% per annum”. (6)

He sees other problems too, in the Asian financial system. The concentration of savings in the banking system has benefited inefficient borrowers at the expense of savers. Bank credit risk has not been properly priced, with bank spreads of 1.5 – 2 % when non-performing loans are around 30% of total assets. This means that banks cannot have been pricing risk properly.

At the national level, an excessive concentration of risk in the banking system is also unwise for macro economic reasons. It means that unexpected economic shocks reverberate strongly in the banking system. The Asian financial crisis of the late 1990’s showed this risk in a dramatic way. Because of the vulnerability of bank balance sheets, which were heavily exposed to foreign exchange risk on top of credit risk, what might have been a sharp, but manageable economic adjustment was turned into a wholesale financial collapse as banks buckled under the strain.

Lastly, Sheng points out that excessive reliance on bank finance tends to work against the promotion of strong corporate governance standards. " In many parts of Asia, the protection of domestic interests such as the legal and accounting professions, as well as restricted entry of foreign financial institutions, has delayed corporate governance reforms."

The need for reform

Sheng believes that all these arguments point towards the need for fundamental reform. Furthermore, he sees powerful demographic and political arguments in favour.

"When you are a young economy" he says " You care more about growth than capital income preservation. However, as the Asian population begins to reach middle age, the financial systems would have to be more responsive to the aging population."

This is certainly beginning to happen to China. Richard Jackson and Neil Howe have written about the problem in "The Greying of the Middle Kingdom" which points to the need in China for rapid development of formal retirement

provision to support growing numbers of older people who lack family support or private pensions. (7)

Why is this a relevant point in relation to the banking system? Because, to quote Sheng one last time " the high costs of bank restructuring in Asia mean that there is either an unfunded fiscal deficit or large holes in retirement funds, which were used to finance the rescue of failed corporations and in meeting fiscal deficits. Given low yields in bonds and equity, there is a serious risk that current mispricing of risks mean that future retiring generations may have to bear the cost of the current generation's policy mistakes".

Taken together, these arguments present a powerful case for reform. The authorities, and particularly Chairman Liu Mingkang of the China Banking Regulatory Commission, are well aware of it. But of course reform is not easy. In any country reforms run up against vested interests. And financial system reform is frequently expensive. The scale of losses in the banking system in China means that there is only one possible source of adequate funding to restore the vitality of banks balance sheets – the government. And I have yet to find a country where providing financial

support to a struggling banking system is a politically attractive move! Bankers are never popular people, particularly if they are seen to have been at least partly the architects of their own misfortunes.

This political problem bedevilled attempts to resolve the Japanese financial crisis for more than a decade. While in China political pressures do not present themselves in quite the same way as they do in a parliamentary democracy, they are real, nonetheless. China has already provided support of some $50 billion to recapitalise its two strongest banks and prepare them for stock market listing. That is an indication of the scale of the problem. Even in China, $50 billion is not small change.

But sometimes unpopular measures have to be taken, for the public good. So, having spelt out the problem in some detail, what menu of solutions can I offer?

A fully comprehensive financial reform programme is well beyond the scope of today's lecture. But I will spell out some suggestions in four areas:

1. The Banking System.

2. Capital Markets.
3. Corporate Governance.
4. Financial Regulation.

1. <u>The Banking System</u>

The need for Banking System reform is well understood by the Chinese authorities and considerable steps have been taken already. Bad debts have been transferred to asset management companies, sizeable capital injections have been introduced into some of the banks, and there have been important management restructurings. As a result, two of the banks – Bank of China and China Construction Bank – have now been upgraded by Standard and Poors to investment grade. This is to the credit of the CBRC, in particular, whose chairman Liu Mingkang, was previously Chairman of the Bank of China.

But it is clear that more needs to be done. That "more" will almost certainly involve further injections of capital, as it is unlikely that all the major banks will be able to meet international capital standards through their own efforts. And if they are to be prepared for flotation on the stock

market, a move which I support, then they will need to present more acceptable balance sheets to prospective investors, whether Chinese or overseas.

But, more importantly, the market needs some confidence that the banks will not get themselves back into the distressed position they found themselves in a few years ago. Can we be sure that the authorities are not throwing good money after bad? Have new credit appraisal techniques been built into the banking system? Have the banks established the appropriate degree of distance between them and their customers, which is an essential feature of a properly functioning banking system? Is political lending a thing of the past?

I doubt that we can yet answer these questions with an unqualified "yes". The financial system is still too intertwined for my taste, with bank officials, regulators and central bankers exchanging positions as if they remained part of the same organisation. There needs to be more creative tension between the banks, their customers and their regulators. Creative tension underpins banking systems in developed economies and ensures that the right degree of challenge is built into the

system of allocating credit. It is, of course, a major cultural change to switch from a process of credit allocation based on quotas and political judgements, to one based on the projected profitability of new companies and new investments.

To create the conditions for this new credit culture, it would make sense to allow more flexibility in interest rates. Current permitted spreads are too narrow. Banks need strong internal audit systems, too. As Bill Rhodes, the senior vice-chairman of Citigroup, argued in the Financial Times in January, these internal auditors 'should report directly to the board of directors.' (8) There is also, he wrote, 'a need to invest heavily in training and development of staff at all levels.' (Bill Rhodes made a number of other suggestions for change – all of which make good sense to me).

Alongside such a properly commercial system, there will remain a role for development funding. Even in a country like the UK there are still funding mechanisms to support small firms and regional development projects on the other, within a framework agreed by the European Union. But those funding arrangements are managed separately

from the commercial banking system, and are not allowed to corrupt the normal processes of credit appraisal and credit allocation. I believe that China needs to work towards this kind of parallel system over time.

If China's commercial banks are to become internationally competitive, they need to face more competition at home. WTO membership will require further domestic opening. That process is now under way. At the end of last year the CBRC opened up 5 more cities to international competition, and relaxed some other constraints on foreign branches. More liberalisation is still needed, however.

Lastly, in relation to the banking system, in the last few years there have been too many " accidents" involving unauthorised credit approvals and sometimes straightforward fraud. Some of these cases have, to the credit of the Chinese authorities, been well publicised as an example to others, and stringent penalties have been imposed on the senior bankers responsible, but it is clear that further efforts need to be made to guard against a recurrence of fraud and corruption in the future.

Only last month the Bank of China revealed another $100 million fraud in Harbin. The CBRC itself said the case 'exposed problems with lax internal management, non-enforcement of rules, non-investigation of violations and light punishments.' (9)

The long-term aim of the Chinese authorities is clear. They want to see strong, well capitalised banks, operating with the discipline of external shareholders to ensure that their decisions are made with a view to maximising profit and shareholder return. Liu Mingkang said recently that 'the sector is getting healthier and stronger' and forecast that 21 banks would meet international standards by the end of this year. (10) But the road ahead is still a difficult and bumpy one, and great determination will be needed.

In a sense, the banking system is where the problems and side effects of a long period of very rapid economic development end up. China's economic performance has been outstandingly successful, but no economy can grow at 8% a year for 25 years without some casualties and accidents along the way, without some projects which did not deliver a return, or companies which turned out not to be viable in an increasingly competitive market place. The

financial impact of those problems has drifted into the banking system. So in overhauling the banks, the authorities are in effect coping with the side effects of the boom.

Finally, as far as the banking sector is concerned, is the state of the banking systems the principal obstacle to introducing exchange rate flexibility, or Governor Zhou suggests? The IMF do not think so. Steven Dunaway said last August: "We don't feel that strengthening the banking systems is a precondition to increasing the flexibility in the exchange rate" (4). He went on: "There's not a substantial threat to the banking system of substantial movements of funds out of Chinese banks into alternative investments."

2. Capital Market Development

The second area where further reform is needed is in the development of Chinese capital markets. As I have explained, both equity and bond markets in China are relatively small in relation to the size of the economy. While there has been some growth, and last year 133 companies issued new shares or bonds (11) the total of

new issuance was only RMB 86 billion, just 5% up on the previous year.

Expansion of those markets would create more diverse capital sources for companies and would provide a more stable and more robust basis for the next phase in the expansion and growth of the Chinese economy. Experience shows that there is a reasonable correlation between the state of economic development and the size of capital markets.

So, if the objective is generally understood and widely supported, what reforms are necessary to allow further progress to be made?

The answers may be slightly different in relation to debt markets, on the one hand, and equity markets, on the other. Let me take the case of the equity markets, first.

In a survey of business in China, published in March of last year, the Economist issued a damning verdict on the Chinese stock market. (12) Chinese equity investment has been very disappointing in recent years, with both the Shanghai and Shenzhen markets in decline. According to

The Economist " much of the decline can be attributed to a massive share overhang: the government still owns two thirds of the equity in the country's 1287 listed firms, and its periodic attempts to sell, or rumours that it may do so, depress prices. On top of that, the market is rigged by the securities industry, made up of 130 largely corrupt brokers, most of which are trying to stave off bankruptcy, having promised investors guaranteed returns they now cannot honour. But the biggest problem is the poor quality of the listed companies".

This is a serious catalogue of problems. The Economist, using its trademark blunt language, may be exaggerating to make a point. The general problem is however, well understood by the Chinese authorities and, particularly, by the China Securities Regulatory Commission (CSRC). They have begun to take a more active approach to disciplining companies which misstate their profits, and to dealing with corruption and mismanagement in securities companies. All these are necessary steps, and they need to be pursued with vigour and consistency. As Chenggang Xu of the Department of Economics here, and his co-author Katharina Pistor point out, "Enforcement capacity at the agency has been increased. And courts have

bowed to pressure to allow investor law suits' (13) But, as they say, China still faces a major challenge to transform its market governance structure from one based on quotas and administrative direction to one based on law and individual property rights.

There are other necessary measures too. The market needs to be open to greater competition. The government needs to explain how it plans to sell its equity holdings. In the long run investors should be allowed even access to stocks, whether they are based in China, or overseas. Securities firms themselves need to be better capitalised. Many are now effectively bankrupt. One promising route is to liberalise the rules governing foreign participation in the securities business in China. The decision to grant Goldman Sachs approval for a large investment in a Chinese Securities firm recently is a positive step.

Another positive move is yesterday's announcement by the CSRC of the creation of a fund to protect investors in bankrupt brokerages, backed by public money. That may make it easier to close down firms who have no future in the industry.

There are important decisions to be made, too, about the degree to which banks may be allowed to operate in securities markets. I suspect that, overtime, we may see Chinese securities companies become parts of broader financial groupings in China itself, or parts of broader international financial entities. This may give some additional solidity and stability to the equity markets themselves.

But the vitality of equity markets depends, fundamentally, on the quality of the companies listed on exchanges. That in turn depends on rigorous enforcement of property rights, and on high quality corporate governance. So, over time, the development of the Chinese stock market will be driven by investors perceptions of corporate governance, and by their confidence in the stewardship of their investments. At present, minority shareholders may perceive that companies offer too little in the way of protection of their interests, and too little transparency.

I will say a little more about corporate governance and transparency in a moment, but first a word or two about the bond market.

Over the last few years the bond market has apparently grown quite rapidly, and far more bond finance has been raised than new equity investment. The interbank bond market has also developed rapidly. According to the China development bank, transactions in 2002 were over 450 times as large as they were in 1997. But most of this new issuance, and secondary market turnover, has been in public sector bonds of various kinds. The corporate bond market is still small by comparison with the total outstandings in government and public sector agency debt. Private bonds apparently make up 5% of the financial stock, but most of the corporate bonds in issue are effectively guaranteed by one state agency or another.

There is relatively little secondary market trading. Most investors buy and hold. Indeed most of the bonds in issue are held by the banks. Liquidity is very low.

As a result, the bond market is not playing its full potential role in Chinese economic development.

If it is to do so, then a number of reforms are necessary. Some of them are quite detailed. There is a need, for example, for efficient and transparent pricing benchmarks.

There is a strong argument too, for independent rating agencies, operating to international standards and independent of issuers, investors and the government. In developed countries capital market rating agencies play a very significant role in providing some comfort for investors. In addition they act as a further stimulus, over and above the statutory regulators themselves, for the promotion of greater transparency and a disclosure to investors. With some kind of rating structure, it will be possible to envisage listing non-guaranteed bonds, to encourage the introduction of credit discipline in the market.

Bond markets in the developed world also benefit significantly from the existence of liquid secondary markets and repo markets which allow short selling. There are also a range of derivative products which create greater liquidity and allow credit risk to be packaged and repackaged to suit the preferences of investors with different types of appetite for risk and return. And there are instruments, notably interest rate swaps, which facilitate hedging strategies.

I recognise that some of the features of debt market in New York and London may not be easy to replicate in China in the short term. But it is important to develop a strategy to introduce reforms and liberalisation over a period. The British government is currently financing a study of how derivative markets might best be introduced. The Chinese Authorities have in many areas demonstrated their willingness and ability to take a long and strategic view. This is another area of policy in which such an approach is necessary. My own view is that the development of a more liquid and vital bond market is well within China's capacity.

3. Corporate Governance

Corporate Governance has become one of the world's fastest growing industries in the last few years.

It has long been understood that there is a relationship between corporate governance standards, investor protection and the vitality of capital markets.

The collapses of ENRON and other companies in the US and Parmalat in Italy gave added impetus to the pressures for reform.

The details vary from country to country, but the general principles of good corporate governance are now reasonably well understood. There is common agreement, for example, on the need for independent directors on the main boards of quoted companies. Indeed it is almost universally agreed that those independent directors should be in a majority. It is also almost universally agreed that companies should be transparent about the way in which their directors are remunerated and about any financial or other relationships a company may have with its board. Those independent directors must see themselves as people acting in the interests of shareholders, and not of the management of the company. And there should be a potential channel of communication between investors and independent directors – though one hopes that channel will not frequently be used in well-managed companies.

These principles are more difficult to apply in the case of state owned enterprises, but the general theory behind

them remains valid. Indeed the CSRC has itself issued a corporate governance code for application by Chinese companies (14). In fact, in my previous job, I participated in its launch in Beijing.

We know in the UK that there can be a considerable distance between the issuance of a code and its full implementation in the corporate sector. And there is still a long way to go in China. I suspect that full implementation will not occur until there is greater pressure from, for example, ratings agencies and indeed from overseas investors. Once again, reform and openness are intimately linked.

4. Financial Regulation

My last subject area is financial regulation. You might expect me, as a former regulator myself, to put this first. But I deliberately leave the subject to the end, because I see the key role of regulators as being to monitor and police developments in markets, and not necessarily to lead those developments. In China, the regulators have been put into the position of leading to a greater extent than would be normal in developed countries. In the

United Kingdom codes of corporate governance have been written by companies themselves, and endorsed and monitored by the regulator. In China, the process is the other way around. Over time, it should be the regulators ambition to step back, but it may be a little while before that ambition can be realised.

The Chinese authorities have adapted and developed their regulatory institutions over the last few years. In the United Kingdom, we have one financial regulator, the Financial Services Authority, covering the whole of the financial system. I regard that as a desirable long-term model, given the ways in which different parts of the financial system now interact with each other. But at the present state of development in Chinese financial markets, with legal restrictions on cross-sectoral alliances, an approach built on three independent commissions, the CBRC, the CSRC and the CIRC, makes good sense. And I particularly approve of the separation between banking regulation and monetary policy – a model increasingly adopted around the world, though not yet in the United States or France – who remain allies in this area, if no other. The Chinese have borrowed extensively from the

UK in this area: the recent new banking law owes a lot to the Financial Services and Markets Act 2000.

I do not have time today to review in any detail the way in which Chinese regulation has developed, and needs to evolve in the future. I will make just one point. In the last five years, since the creation of the Financial Stability Forum in 1999, following the Asian financial crisis, the pace of change in international financial regulation has accelerated sharply. In the past, the international groupings of regulators, the Basel Committee, IOSCO and the IAIS, developed essentially voluntary codes. Countries could choose whether or not implement those codes in their own jurisdictions. In the case of the Basel Accord, it was theoretically the case that banks could not operate internationally without meeting the requirement for 8%, but there was no effective policing of the quality of regulation, or indeed the quality of capital, in individual countries. And we now know that banks from some countries, notably Japan, did continue to operate internationally without meeting the standard.

In the last few years the policing of international standards has been significantly strengthened. While in

theory they remain voluntary, in practice that is now scarcely the case. The IMF have set up a department which carries out financial sector assessment programmes, looking at the extent to which an individual country is meeting the international standards set out by the regulatory groups. I am well aware of the seriousness of this initiative since an FSAP was carried out in the UK while I was Chairman of the FSA. It was a very detailed and comprehensive exercise. So far, no formal conditionality is attached to these assessments, in terms of Fund support, but the results of those assessments influence the views of senior IMF and indeed World Bank staff. They know from the Asian financial crisis of the late 90's that poor quality regulation of financial systems can contribute to economic collapse.

So any country, whether developed or developing, must now appreciate that the quality of its financial regulation will be put under the international microscope. I believe the Chinese authorities have understood this point very well, and it is one reason why they have established international advisory councils to help them develop standards and practices meet international requirements. As I have explained, there is further progress to be made,

but the direction of change is clear. I have been privileged to be allowed to take part in this process as a member of the advisory councils of both the CBRC and the CSRC.

The forward agenda is very challenging. There is a shortage of technical and indeed interpersonal skills needed for effective regulation. That is true in developed markets, too, but is particularly the case in developing countries. So one needs to be realistic about the extent to which countries can meet international best practice in every respect – and indeed I have argued elsewhere that some of the international standards are perhaps excessively detailed and complicated, and not fully adapted to the needs of emerging markets. The principles, however, are valid.

In conclusion, let me reformulate the questions I posed at the outset. "Are there weaknesses in the Chinese financial system which still need to be corrected? Are Chinese financial institutions ready to compete with international firms? Does China yet have the financial system which it will need in the next phase of its development?".

A very simplified summary of what I have said so far would conclude that the answers I have given to these three questions were, in each case, “no”. But this is not a pass / fail examination.

So a fairer summary would be to say that further progress is needed in all areas, there are considerable obstacles still be to overcome, but the direction of change is the right one.

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