CHINA'S FINANCIAL MARKETS

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I am very pleased to be addressing this group of bankers and scholars on the topic of financial markets in China. It should come as no surprise that, in my capacity as a central banker, I see financial markets evolving from a foundation of a safe and sound banking system. The kinds of institutions and other elements needed for financial markets to work properly include commercial banks, investment banks, debt and equity issuance, and securities markets. But more than creating mere institutions, China must create dynamic growth in the economy and an environment of trust in the system that will enable financial institutions and markets to function efficiently. In the U.S. experience, dynamic growth comes from innovators and entrepreneurs, and these small, new businesses typically turn to banks and not securities markets for their financing needs.

Looking at the vast picture of reform in China, it seems to me that the best way to move toward a market-based economy is to encourage the growth of small businesses and the entrepreneurs who run them. This in turn, means a move toward banks since they are the essential link between the credit markets and entrepreneurs. Today, then, I would like to discuss the attributes of a healthy banking system and the kind of environment that is necessary to allow banks to flourish.

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I have based my remarks on the principle that what works for banks will also work well for financial markets. Put slightly differently, if banks are not doing well in an economic system, then financial markets will also suffer. Before I discuss my views on the next steps China should take on the road to efficient financial markets, I would like to give some context to the development of those markets by first outlining the actions China has already taken to open its economy. Then, because I believe we learned some lessons about and made some mistakes in dealing with our financial institutions and markets in the United States, I will briefly review some of these.

Steps China Has Already Taken

Although there have been many areas of economic reform in China over the past 15 years, I would like to focus on only a few. The first and most necessary reforms were aimed at changing the agricultural sector, essentially by freeing farmers from central planning and allowing them to sell surplus products at market prices (after they had filled their quota from the government at a fixed price). More progress toward a market-based economy is being made in the agricultural sector in the areas of distribution and pricing, in the one case by creating national and regional wholesale markets to encourage farmers to supply markets directly and in the other by allowing more prices to be set by the market.

In the financial sector, banking reforms have led from a one-bank system, which had the People's Bank of China serving as both central bank and commercial bank, to something approximating a multi-bank system. In the current system, commercial banking activities have

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been taken out of the central bank and given to banks specializing in certain sectors, such as agriculture, construction, and foreign exchange. Formerly, monetary policy was closely tied to the physical plan that specified output targets. Since most prices were fixed, an increase or decrease in the money supply did not affect prices. But with the market-oriented changes, monetary policy has become more important in managing inflation, principally by controlling credit and interest rates. Continued reforms in the area of monetary policy seem to be leading toward more reliance on the determination of interest rates through market forces. Also in the financial sector, securities reform has apparently attracted the most attention with the establishment of two stock exchanges in Shanghai and Shenzhen and the listing of several Chinese companies.

Other significant reforms that have enhanced the view of China as a more open economy include the de-control of prices and reduced controls on exports and imports. Notwithstanding these and other reforms, the Chinese system is still based on government allocation of credit, which is far from the ideal of an economy in which the supply and the demand of the marketplace determine where credit flows. Change cannot happen overnight, though. The challenge of policymakers, as I see it, both in China and in other countries, is to move from the reality of what exists towards one that approaches the ideal version that exists only in a perfect world. Policymakers also understand better than anyone that moving from the real to the ideal cannot be done quickly and that some compromises must be made.

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With that in mind, let me briefly discuss the less-than-smooth evolution of financial markets in the United States. Fragmented and diverse are the key words for the U.S. financial markets system. The fundamental reason for this fragmented system is that the United States was formed by the voluntary decision of states. When the United States was created in the late 1700s, there was much support for states to continue to exercise some power rather than ceding all power to a centralized government. This concern for governmental power at the regional level also kept the banking system fragmented until quite recently. For instance, each of the 50 states has a commissioner of banking or equivalent regulator, even though there is also regulation at the federal level.

Populist suspicions of finance and financial markets also caused a number of unusual features in the development of our institutions and markets. Most tellingly, a central bank was missing for 100 years, once again reflecting Americans' aversion to centralizing power in any one entity. The structure of the U.S. central bank, the Federal Reserve, reflects the desire to ensure that people throughout the nation have impact on our policies.

The collapse of the stock market in 1929 led Congress to separate commercial and investment banking activities into entirely different organizations. This division was enacted in the belief that commercial banks would turn bad loans into equities and sell them to unsuspecting customers. Even though many other restrictions were placed on banks, and some could have truly stunted institutional growth, this did not happen because of innovation on the part of both banks and other financial institutions.

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Why Banks Are Critical

Now let me turn to my central thesis that a sound banking system is critical as a first step toward liquid and healthy financial markets in a market-based economy. Essentially, when a nation decides to transform its economy from one that depends on central planning to one that allows markets to determine prices, it is not enough to privatize existing public industries and then to raise cash by issuing securities or other claims on their assets. These are typically very large organizations and, by their very nature, not likely to meet the diverse needs of a large population, nor will they be flexible enough to change as quickly as needed in response to external shocks or shifts in consumer preferences. To sustain a market-based economy, it is necessary to let small businesses contribute to the growth and dynamism of the economy.

In any economy, but certainly in the Chinese economy, small business are not limited to entrepreneurs in the cities; even farmers run small businesses. If there is any secret to the overall vibrancy of the U.S. economy, it is that small businesses innovatively find ways to discover new demands in the system and, perhaps more importantly, also find more efficient ways to produce. In order to support this critical element of any market economy, there must be commercial banks, because banks provide the financing that allows small businesses to expand. That is because small businesses cannot hope to attract the attention of the securities markets for the very reason that they are too small to issue securities efficiently. They cannot easily provide the multitude of market participants with information about their businesses. Banks, though, are capable of assessing this information to determine the credit-worthiness of businesses on an

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individual basis. Thus, banks are needed in early stages of economic development when information gathering and transmission are not well developed.

In sum, banks play an important role in financial markets because their role is to look at unique and hard-to-classify demands for funds that cannot readily be turned into securities. A market economy needs to have intermediaries that do this for small- and medium-sized businesses. In China today, the major banks are one-industry banks. They also generally serve major industries, leaving few methods by which to support small business and also leaving them vulnerable to failure if the major industry they serve flounders. It seems to me that another advantage of a strong banking system in China would be that small, new businesses could find the financing that would allow them to base themselves in a market economy from the beginning. These businesses would both educate by example as well as produce efficiently and would contribute greatly to the development of a market economy.

The Environment Necessary for Banks to Flourish

From my point of view as a central banker, the key to continued long-term, stable growth in China--in addition to the macroeconomic policies that have already been put in place--depends on having a strong financial system in place, and particularly a solid banking system. But what are the requirements to creating such a system and then keeping it safe and sound?

In the first place, I believe a strong financial system requires an independent central bank to ensure that the making of monetary policy is separate from fiscal decision-making. Moreover,

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a strong financial system requires an independent regulatory authority. Personally, I believe that the central bank should perform both roles. However, the main point is that the entity responsible for bank supervision must not be subject to short-term pressures from politicians. Still, while the central bank and regulatory agency should be independent, they must remain accountable.

Why are such structures so critical to the future of China? First, a strong and independent central bank would take steps to reduce and contain inflation. An independent monetary authority would help ensure that the fiscal authority could no longer print money to pay its debts. In turn, the danger of hyperinflation would be greatly reduced.

Second, I would like to emphasize the importance of supervision and regulation in the broader scope of a financial structure. Because the world is driven increasingly by technology linking countries more closely, unsound banking practices pose threats to more than the home country. The collapse of BCCI is an obvious example of unsafe banking practices that have the potential to disrupt global banking. The closing of this international bank raised serious concerns about possible problems that may arise when proper supervisory and regulatory controls are not in place. Generally speaking, the kinds of controls necessary to prevent such situations are enforced by strong, independent banking authorities. In order to ensure the security of the international banking system, it is important that all countries have an independent supervisory authority and that all financial institutions be subject to comprehensive and consolidated supervision.

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A third, and perhaps most important, benefit of an independent central bank is that it greatly enhances the credibility of a financial system. In turn, private capital is more readily attracted to banks and other financial intermediaries. As a result, the financial system itself becomes an engine of privatization and growth.

Besides an independent monetary and regulatory authority, a second requirement for a successful market-oriented economy and for financial markets is a legal system that provides clear and predictable rules. Among the evolving economic and political reforms taking place in China, one area that has not yet become firmly implanted is private property and contract law. In many countries, such laws are taken for granted. However, in countries where nationalization or centralization has been a recurring theme, the concept of private property exists on shaky grounds. Setting up an enduring legal system as a foundation for newly privatized companies and property is a daunting challenge, but one that must be met. Otherwise, private and corporate citizens will operate as though the government could take their property at a moment's notice. Such a mind-set leads to short-term thinking and can often cause capital flight.

Drawing again on the U.S. experience, let me point out that even in a democratic society with a strong foundation of private property rights and the rule of law, we still have stumbling blocks. For example, in the United States where environmental protection has become of significant social concern, the activities of banks are sharply curtailed when the legal status of projects that entail risk to the environment becomes uncertain. To give another example, as the United States moves to the information super-highway--a mix of computers, telephones, and

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multimedia--we must begin to contend with the issue of which firms can provide what services via the various channels of communication. This problem is not crippling yet because, actually, uncertain market demand and technology are the bigger constraints right now. But if we do not institute satisfactory rules that reflect the evolving marketplace, then the United States could fall behind countries that have greater foresight. The lesson to be learned from these circumstances is that property rights must be clearly delineated and clear, predictable rules established so that all involved in financial markets know who owns what and which rules apply.

What Not to Do When Establishing Financial Markets

In evolving toward financial markets and a market-based economy, these are two things a government must do, but there are a few I would like to point out now that a government must not do. First and foremost, the government must not allocate credit, either directly or indirectly. In the U.S. experience, national- and state-guaranteed industries have been very costly. Let me give as an example the billions of dollars spent to deal with the savings and loan industry in the 1980s. We got into this predicament because the government sought to encourage the financing of homes and created a class of institutions that were largely limited to making long-term, fixed-rate mortgage loans. These mortgage portfolios turned out to be costly when interest rates rose significantly. The government compounded its credit-allocation error by ignoring the need for these institutions to raise capital. In fact, it allowed the savings and loans to diversify their portfolios after they had already lost much of their economic capital. In turn, this led them to take on more and more risk especially because their deposits were seen as insured or guaranteed by the government. This unrestrained expansion of risk-taking ultimately led to the collapse of

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the savings and loan industry, and U.S. taxpayers shouldered the cost in the amount of $150 billion. In my view, the moral of this story is that government must be careful to avoid political allocation of loans and must put strict limits when it guarantees private liabilities. If it does decide to allocate credit--either directly through mandates to firms or indirectly through guarantees--then government must monitor the overall risk to prevent the sort of debacle we experienced with the savings and loans.

Another lesson from the U.S. experience I would like to discuss pertains to what has been called the regulatory dialectic. Every government finds good reasons to set up rules and regulations to govern the conduct of business and finance. But based on the experience we have had in the United States, I believe it is best to think carefully about the need for rules and the best form to use. The reason is that rules limit profit opportunities and encourage innovation that erodes them. Financial institutions and markets will always seek to avoid rules in order to increase profits. That means that institutions will follow the letter of the law, while still managing to accomplish the economic functions that had seemingly been prohibited. Then government either make the rules more complex or considers whether trying to regulate the function is good policy. For example, the United States imposed minimum capital-to-asset ratios for banks in the early 1980s. These did not take account of the riskiness of assets or the commitments made by banks that are not reflected on their balance sheets. These are known as off-balance-sheet items. As a consequence, the investment by banks in safe, liquid assets was reduced while their off-balance-sheet activities ballooned. Fortunately, the error was recognized before it caused a problem.

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Let me acknowledge that legal avoidance of government regulation is not all bad. For example, the prohibition of interstate banking encouraged the growth of other financial firms that are nationwide and can compete with banks in the provision of many services to business and consumers. This innovation accelerated as our communications systems improved and, no doubt, lowered the cost of these services to consumers and businesses. We now have a new interstate banking law in the United States, and recently passed statutes are facilitating this because the policy was reconsidered. The important lesson, however, is to consider likely market response when devising rules and regulations and to reconsider whether the initial goal of the policy is still appropriate.

Before I leave this discussion of what to do and not do, let me also add that banks must be well diversified. By drawing on some experiences in the United States with one-industry banks, I would hope to sound a warning bell. The United States does not have banks set up strictly to serve one sector or industry as China does. However, we have suffered the same consequences as if we did. To give one example, the state of Texas did not allow banks from other states to enter its market, nor did it initially allow its own banks to open branches within the state. By the 1970s, many large banks had ended up concentrating their assets in loans to producers of oil. They were not diversified. However, when oil prices began to decline in the early 1980s, the oil producers and the banks in Texas were greatly affected. Many of the big Texas banks failed at a cost to the government and ultimately the taxpayer. Moreover, the attempt to keep banking a locally owned and operated industry was reversed as Texas banks were

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ultimately absorbed by out-of-state banks whose capital had not been eroded by oil price declines since their portfolios were far more diversified.

Similarly, agricultural banks--those that had at least 25 percent of their loans in farming--also were hit in the 1980s. Farmers who had bought land and equipment based on the expectation of continued double-digit inflation could not meet their debts when it became clear that the Federal Reserve would continue to pursue a policy to lower inflation. Many agricultural banks failed or were absorbed by more diversified institutions after their capital was eroded by loans that had gone bad. The lesson to be learned from this history is to discourage banks from concentrating their lending narrowly and to allow them to diversify their lending base.

Overall, I have dwelt on examples from the United States because I know it best and do not consider myself to be an expert on the systems in other countries. It is a fact that the U.S. financial markets are the largest and most innovative in the world. Yet along the way to these well-developed markets, we have made some spectacular errors. I have offered my examples in the hope that simply by avoiding some of our errors, China can greatly benefit. In fact, China has already shown that it can take advantage of being a latecomer to financial markets. I give as an example the Shanghai stock market. From its inception, it did not copy the U.S. stock markets and issue pieces of paper known as stock certificates. Instead the Shanghai stock market instituted a so-called scripless system connected by satellite with receiving stations in 50 brokerage houses in 43 cities throughout China. (In fact, I was amused to read that the president of the Shanghai stock exchange has said that he is surprised that Westerners do not like the scripless system,

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because we invented credit cards to substitute for paper money. On the other hand, he also pointed out that before the successful introduction of the scripless system, he thought there might be some resistance in China because the Chinese invented paper.)

Conclusion

In conclusion, as China's next step toward establishing fluid and efficient financial markets, it would make good sense to put the effort into setting up a traditional banking system that includes an independent central bank with supervisory and regulatory powers and well-diversified commercial banks that serve small businesses. China has made good progress with stock markets, particularly here in Shanghai, which has helped to attract investors for large developments, such as the Shanghai-Pudong project. A market economy, however, still needs to have intermediaries that cater to the financing needs of small and medium-sized businesses. I believe a banking system built on a foundation of safety and soundness will go a long way toward creating the kind of broad and strong financial markets to which China aspires.

Finally, as China continues on its remarkable road to economic transformation, may I also say to each of you, Gong hsi far tsai. [Pronounced *kong-see far-tsigh,* this phrase means literally "I wish you good fortune."]

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