HOW CAN CHINA'S FINANCIAL MARKETS MATURE INTO RELIABLE INVESTMENT VEHICLES[1]

China has gone a long way in transforming from a centrally planned command economy into a market oriented economy. By upgrading its legal framework, infrastructure, supervisory framework, and the knowledge and standards of its people, China's financial markets can mature into reliable investment vehicles. In view of the close financial ties with the Mainland, Hong Kong can play an important role in facilitating China's financial development.

Introduction

China has gone a long way in transforming its centrally planned command economy into a market oriented economy. China has taken very bold steps to commercialize its banks and to build a stock market and bond market from scratch. It is not surprising that the reform process has not been plain sailing all the way and there are bound to be bumps every here and there. As China is undergoing very rapid and fundamental changes, it is often difficult for an outsider to keep track of the latest developments and to understand fully the implications of the new reform initiatives. In the limited time available, I would like to offer a few observations on how China can enhance the robustness and efficiency of its financial markets.

Key Factors For Market Development : "LIPS"

For any financial market, be it in China or elsewhere, to mature into a reliable investment vehicle would depend on what I would describe as the **LIPS** factors. **LIPS** - "**L**" stands for Legal framework; "**I**" stands for Infrastructure of the financial markets; "**P**" stands for People and Products; and "**S**" stands for Supervisory Framework.

Legal Framework

It needs very little explanation as to why an appropriate legal framework is important for any financial market to function effectively. Without legal clarity and certainty based on which financial contracts and activities are executed, it is difficult, if not impossible, for the financial markets to become reliable and predictable channels of intermediation between savings and investments. In the Mainland, there has been impressive progress in the development of its legal framework. The past few years have witnessed the promulgation of the Companies Law, the Bankruptcy Law and the Commercial Bank Law which provide the basic legal infrastructure for commercial and financial transactions. The Securities Law, once enacted, would further strengthen the legal framework.

Obviously a robust legal framework is more than passing a few legislation. It is relatively easy to borrow or even copy the laws of the more developed markets, but these laws would mean very little if they are not supported and enforced by a strong legal profession and an independent judiciary. It is understood that there are only slightly more than 100,000 practicing lawyers in the Mainland. This translates into a ratio of only one lawyer for every 13,000 of the population which is very low comparing with the developed markets. In Hong Kong, there is about one practicing lawyer per 1,200 citizens, ten times higher than in the Mainland. The existing pool of lawyers is clearly inadequate in terms of numbers alone to support the rapidly growing and increasingly sophisticated financial markets in China. Furthermore, a consistent and determined application, free of political interference, of the laws is necessary to instill clarity, certainty and confidence in the legal process.

[1] This is the text of the speech by Norman Chan, Deputy Chief Executive of the Hong Kong Monetary Authority, at the China Business Summit in Beijing on 22 April, 1998.

Infrastructure

A rather common phenomenon in many developing economies is that the policy makers have the tendency to give greater attention or higher priority in the building of physical infrastructure than market infrastructure. This is understandable as it is so obvious that without the physical infrastructure, such as power plants, roads, airports etc., it would not be possible to achieve the desired economic growth. However, it is less obvious why and how market infrastructure such as a robust clearing and settlement system for the securities and foreign exchange transactions would be essential to the proper functioning of the financial markets. Even worse would be the inability to recognise how economic growth cannot be sustained in the long run without properly functioning financial markets.

Amongst the various market infrastructure, payment and settlement systems carry special significance. Payment and settlement system is like the plumbing system at home that most people do not see or think about and therefore take for granted until something goes wrong. In Hong Kong, the average daily turnover of the interbank payment system is US$54 bn and each year the system settles payments with an aggregate value amounting to almost 80 times of Hong Kong's GDP. The risks involved in the system can be very big and it is essential that a robust system be in place to control and reduce settlement and other related risks. In this context, I am pleased that China is taking the necessary steps to upgrade its payment infrastructure and a new interbank large value payment system operating on a real time gross settlement basis (RTGS) is scheduled to be in place in 1999. Once this RTGS system is in place, it will provide the platform for the introduction of a more robust clearing and settlement facility for the securities transactions in the form of Delivery versus Payment, which in the more advanced markets is regarded as absolutely essential by the participants for the purpose of controlling risks.

Another important piece of market infrastructure for the development of a mature debt market in the Mainland is the creation of a reliable benchmark yield curve for RMB, based on which the pricing of RMB bonds and other interest rate derivatives of different maturities can be fixed. In most developed economies, the benchmark yield curve is established by the yields of the treasury bonds, which usually form a big, if not the biggest, component of the domestic debt market. However, there are several problems with the treasury bond market in the Mainland. In 1996, the Ministry of Finance adopted a new issuance procedure by offering 2 and 3 year treasury bonds through competitive tenders. This is a move in the right direction as the treasury bonds were no longer sold through administrative allocation. However, under this market-oriented approach, the yields of bonds are some 200 basis points higher than the rates for two year term deposits rates with the commercial banks[2]. This is an anomaly because one would expect that the treasury bonds, which carry government risk and are of far higher liquidity, should attract a lower yield than those "illiquid" deposits held with commercial banks.

There are many reasons for this anomaly but clearly inadequate market infrastructure is a major contributing factor. For any bond market to function properly, there must be in place an efficient system of primary and secondary dealers for the distribution and trading of the bonds. Moreover, a safe and efficient depository, clearing and settlement system would not only reduce transaction costs for the market participants but also reduce risks to the investors and in turn contribute to market stability. As you may recall, the treasury bond repo market in the Mainland ran into problems during 1995 and 1996 partly because some of the financial intermediaries made use of customers' treasury bonds without the customers' knowledge or consent and, worse still, treasury bonds that did not exist at all, to conduct "repo" trades to obtain cash so as to undertake highly speculative activities in the market. I imagine that

2 For example, the 3-year T-bonds issued in May 1997 were trading at a yield of 8.23% on 2 April 1998. Whereas the 2-year and 3-year term deposit rate stood at 5.58% and 6.21% respectively. For longer maturity, the gap is narrower. For example, the 7-year T-bonds issued in November 1996 were trading at a yield of 7.67% on 2 April 1998. The 5-year term deposit rate was 6.66% on that day.

the problem would not have occurred or, even if it did, would have been detected much earlier, if a robust depository and clearing system was in place because the transfer of securities holdings and cash would be subject to more stringent rules and scrutiny. Inadequate market infrastructure can turn a very common and safe investment instrument, such as the repo of treasury bonds, which constitute huge and liquid markets in the developed financial markets such as the US, into a major source of market instability.

People and Products

As explained earlier, a legal system or financial system, no matter how well designed or structured, can only be as strong and effective as the people who participate in it. It is going to be a long term and ongoing process to upgrade the knowledge and standards of the people. It will take quite some time to develop a big enough pool of highly qualified and experienced professionals in the fields of law, accounting, auditing, commercial and investment banking etc. The challenge is huge because the educational system has to grow fast enough to meet the rapidly growing requirements of the financial markets. Moreover, it takes time for people to gain exposure, experience and maturity. Apart from the professionals, there is also an urgent need to upgrade the understanding of the investors who take part in the financial markets. Many investors in the Mainland do not have adequate awareness and understanding on how the financial markets operate and the risks involved. Attracted by the apparently high returns promised, the investors often neglect the need to assess the risks involved until their investments have turned sour for one reason or another. While it is probably inevitable that most investors have to learn the lessons the hard way, there is quite a lot that the government can do to cultivate a more balanced and healthy understanding, especially amongst the retail investors, of the relationship between risks and returns of financial investments.

As far as the mainland investors are concerned, there is a shortage of financial instruments for them to invest. This is a reflection of the lack of sophistication of the financial markets in China. The domestic savings rate is very high in China and the investment outlet has been rather limited. The public will become more and more unwilling to invest their savings only in the form of bank deposits, although bank deposits offer a very safe investment vehicle. There is a need to develop both the money and capital markets so that a greater variety of financial products can be offered to the investors, both at the institutional and retail levels. The development of the unit trust market is definitely a move in the right direction, as unit trusts can achieve economies of scale and risk diversification which individual small investors would not be able to achieve. Once again, it is essential to ensure the people participating in the marketing, trading and supervising of these financial products possess the necessary professional skills and integrity so that these products can become safe and reliable investment instruments.

Supervisory Framework

I am sure that there is little argument that China must strengthen its supervisory framework in order to make its financial markets safe and reliable. This is by no means an easy task and the challenges faced by the Mainland regulatory authorities are daunting. The regulatory regimes are going through an era of very rapid changes and reforms. The commercialization of the banking system and the interest rate market will demand new skills and approaches that the supervisors have had no prior experience in handling. New financial products, in particular derivatives, are emerging as financial liberalization takes place. Once the restrictions on capital account in the Mainland are relaxed in due course, the financial markets will face even greater challenge as foreign competition and new products will emerge at a rapid pace. The supervisors will have to do a lot to catch up, let along getting ahead of the game.

Similar to the case of legal framework that I have already addressed, an effective regulatory framework should possess several features. It should convey adequate **clarity** by promulgating comprehensive and transparent regulations demanding sufficient disclosure of information by those being regulated in line with international standards. It should be applied **consistently** so that market practitioners can predict the outcome of their actions. And the framework should be **credible** which will require a fair and equitable application of regulations to different market participants. Furthermore, to conduct supervision on a **consolidated** basis will enable the regulator to supervise financial conglomerates which operate a wide spectrum of financial activities.

There is nothing new for me to suggest that the Mainland authorities should strengthen their regulatory capability. However, I would like to raise one particular reason, i.e. the moral hazard problem, why China must beef up its supervisory capability. The moral hazard problem arises because most of the key financial intermediaries, such the commercial banks, trust companies, securities firms are either owned directly or indirectly by the central or the provincial government authorities. While very few, if any, carry an explicit guarantee by the state, it is commonly perceived by investors and depositors, both domestic and in due course overseas, that the state will bail out these institutions or at least the depositors, investors and creditors, if these institutions should run into financial difficulties for whatever reasons. Such perception would severely weaken the discipline amongst the investors in making investment decisions, as they would opt for those investments offering the highest yields or returns, without giving due regard to the risks involved. As the financial intermediaries and corporates would have to undertake more risky investments in order to earn sufficient profits to repay the depositors or investors, it would in turn lower the quality of assets held by financial institutions and corporates.

As pointed out by many economists, including Paul Krugman, one of the main lessons that one can learn from the recent financial turmoil in Asia is that a poorly supervised banking system with an implicit guarantee by the state has been a recipe for financial disaster. Under such a scenario, depositors and investors would be willing to lend to or invest in the financial intermediaries without regard to the underlying financial health of the institutions or the likely risks involved. At the same time, the financial intermediaries are more likely to undertake risky investments in pursuit of high profits. As we have witnessed in some Asian economies, the outcome can be quite devastating. In the case of the Mainland, one can argue that, as far as the men-in-the-street are concerned, the credit standing of the state-owned commercial banks are as good, if not better, than the Ministry of Finance, as reflected by the higher yields demanded for Treasury bonds than bank deposits. There are many other financial institutions and enterprises which, due to their close governmental connections, are perceived to be carrying implicit state guarantee.

It should be emphasised that the moral hazard problem is by no means unique to China. A classic example of this problem is the Savings and Loans (S&Ls) debacle in the US in the 1980s, where depositors had no incentives to distinguish among the credit-worthiness of the S&Ls because their deposits were guaranteed explicitly by a national insurance arrangement and implicitly by the Federal Government. And this has in turn encouraged excessive risk-taking by S&Ls. In the end, it was the US tax payers who had to bail out the S&Ls at an estimated cost of US$200 bn.

The moral hazard problems arising from the state's ownership of the financial intermediaries in Mainland China is likely to become more acute when China liberalises its capital account transactions in the future. The euphoria on the part of overseas investors towards rapid economic growth and attractive investment returns in China will make available easy credits for Mainland financial institutions and enterprises. As it would be difficult for investors to conduct detailed risk-return analysis because of inadequate disclosure and difference in accounting standards, there is naturally a tendency for foreign capital to flow to financial intermediaries which are perceived as carrying an implicit government guarantee. This may encourage imprudent lending and investment behaviour, leading to bubbles in asset markets or over-investment in economic sectors which already exhibit signs of over-capacity. For a while, the problem would be masked when foreign capital keeps pouring in. However, as seen in the recent Asian turmoil, when investors suddenly perceive the situation as unsustainable, the pull out will be sharp and damaging.

It is not easy to overcome the moral hazard problem because it is neither appropriate nor adequate for the state to warn investors that it will not bail out the state-owned financial intermediaries running into difficulties. The investors or depositors are likely to ignore the "health" warnings until such time when a state-owned financial intermediary failed and the state refused to bail out. However, no supervisor would like to come to that stage if at all possible. A more effective way to deal with the moral hazard problem is through vigorous supervision to ensure that the financial institutions do not take excessive risks in their operations. Serious efforts should also be made to enhance the transparency of financial institutions. Disclosure of sufficient financial information ensures that the depositors and investing public are adequately informed. This is an effective discipline against excessive risk taking by the financial institutions.

Hong Kong's Role in the Development of China's Financial Markets

Let me now turn to Hong Kong's role in the development of financial markets in the Mainland. Since the beginning of the reform process of China, Hong Kong has become the most important source of external investment in the Mainland. Hong Kong channels not only investments from within Hong Kong but also from the Asian region and the rest of the world into China. Given Hong Kong's competitive position in this intermediation process, investments in the form of foreign direct investment (FDI), syndicated bank loans, bond issuance and equity listing have been channelled through the banking and securities markets into the Mainland. Take the listing of State-Owned Enterprises (SOE) in Hong Kong as an example. There are altogether 40 SOEs listed on the Stock Exchange of Hong Kong in the form of "H" shares at present. Since the first listing in mid-1993, a total of US$7.62 bn of funds have been raised through global placements and public subscriptions in Hong Kong.

International capital prefers to flow into China through Hong Kong because Hong Kong offers a safe and reliable channel for investing into China. Quite apart from the capital account restrictions, the Mainland financial markets have not developed to a stage that many overseas investors feel comfortable with. It is worth mentioning that, in the case of the listing of SOEs in Hong Kong, the process has not only enabled the enterprises concerned to raise foreign capital funds, but has also helped upgrade their corporate governance since they are required to comply with all the listing rules in Hong Kong, which adopt international standards regarding accounting and information disclosure.

Given the experience Hong Kong has accumulated in developing and supervising its financial sector, it can play a useful role in facilitating an upgrading of the LIPS factors in China's financial development. In respect of the development of the Legal framework, Hong Kong can offer its experience and advice in the drafting of financial laws to cope with the emergence of a wide variety of market activities. Indeed, the Hong Kong Monetary Authority has provided its comments when the Mainland's Central Banking Law and Commercial Banking Law were being drafted. In terms of Infrastructure, the Hong Kong Monetary Authority has been providing technical assistance to the Mainland in areas such as the development of interbank payment system and clearing, settlement and depository arrangements for debt securities. In view of the close financial ties between Hong Kong and the Mainland, we are also actively exploring opportunities for mutual co-operation in the development of market infrastructure. An example is the development of a Payment versus Payment linkage between the RMB and Hong Kong dollar payment systems once real time gross settlement capacity is available in the Mainland. As regards People as well as the Supervisory Regime, we have been sharing our market development and regulatory experience with our Mainland counterparts with a view to upgrading the skills and expertise of their market participants and supervisory staff.

In serving as a centre for intermediating funds into the Mainland and in facilitating its financial development, Hong Kong has played a crucial role in the economic growth of China. In turn, Hong Kong has also benefitted from this process, as evidenced by the growth of the financial services industries in Hong Kong. I have no doubt that further liberalization and deepening of the financial markets in the Mainland would benefit not only the Mainland but also Hong Kong.