Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

3-7-2007

Prepared Remarks by Treasury Secretary Henry M. Paulson, Jr. on the Growth and Future of China's Financial Markets

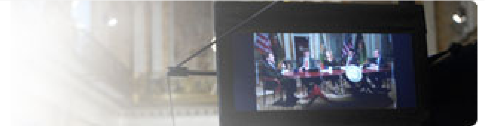
Henry M. Paulson Jr.

https://elischolar.library.yale.edu/ypfs-documents/7549

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library. For more information, please contact ypfs@yale.edu.

U.S. DEPARTMENT OF THE TREASURY

Press Center



Prepared Remarks by Treasury Secretary Henry M. Paulson, Jr. on the Growth and Future of China's Financial Markets

3/7/2007

HP-301

Shanghai, China – Thank you very much. I am very happy to be here in Shanghai, and I appreciate your warm welcome. In December, I was in Beijing for the first meeting of the U.S.-China Strategic Economic Dialogue. After that meeting, I decided that I should return to Shanghai to speak about the growth and the future of China's financial markets.

In my travels here over the last 15 years, I have seen this city grow to be a cosmopolitan center of finance and culture. Shanghai has in many ways come to symbolize the economic dynamism of China. It is an example of China's emergence as an important participant in the global economy. So it is only fitting that I am making this visit against the backdrop of a global economy, which over the last several years has been as strong as any I have seen during my business lifetime – an economy that has been characterized by strong growth, low inflation, and high levels of liquidity.

As China has grown, the relationship between the United States and China has become more important than ever before. We welcome China's growth and integration into the world economy – it benefits the Chinese people, and the people of the world. Today, China is transitioning from a planned economy to a market-driven economy and there is no doubt that this process will continue for a number of years. But because of its size and its role in world markets, China is already a global economic leader and deserves to be recognized as a leader. And with leadership comes responsibility. Decisions about the pace and shape of your economic reforms, as well as policies relating to energy and the environment, affect nations around the world.

Since the economic relationship between our two countries is an important part of the overall relationship, I have focused intensely on China from the day I became Treasury Secretary. To manage the economic relationship between our two nations on a long-term basis, President Bush and President Hu established the Strategic Economic Dialogue. We were very pleased with our first meeting in Beijing in December, and will meet again in Washington in May. Because the U.S. and China share many strategic economic interests, I am confident the SED will help us make progress on fundamental long-term structural economic issues, as well as on very pressing short-term issues.

The economic relations between our two nations are vital to the future of the global economy. And I believe we share many of the same goals – the policies of openness and market principles that the United States advocates are similar to those that China's leaders have embraced to bring balanced, harmonious growth to your nation. As I have said many times, our policy disagreements are not about the direction of change, but about the pace of change. It is worth noting that over the last five years, the U.S. and China accounted for over 50 percent of global growth. Make no mistake about it, China's continued economic success is not only vitally important to the people of China, but also to the rest of the world.

I want to take the time today to lay out why I believe increasing the pace of reform in your financial services markets is in the best interest of China's future – to spread prosperity to all the people of your nation, to promote greater stability here and abroad, and to demonstrate leadership in accordance with your global economic presence.

I. Overarching Importance of Financial Markets

I am a strong believer in the power of financial markets to support growth and development, and help a society fulfill its aspirations and needs. Through more than 30 years of work in the global financial sector – including many visits to China – I have witnessed the extraordinary global growth in financial services. And I have seen how deep, liquid, and efficient capital markets pave the way for prosperity, opportunity, and economic dynamism, while minimizing and diversifying risks.

Many years of hands-on experience working in my own country and in nations and markets around the world has convinced me that open, competitive, world-class financial markets are the backbone of stable and balanced growth.

Efficient and competitive financial sectors help allocate scarce resources to their most productive uses and generate significant multiplier effects for economic growth. Markets connect money with ideas and ambition – which are the lifeblood of innovation and dynamism. They

offer a diverse array of financing channels, providing for more innovation and a lower cost of finance. They allow new financial products to enter the markets and help people, young and old, acquire consumer goods and make the investments they need to meet their financial goals, provide retirement security, and insure their families against risk. Deep and liquid capital markets also increase stability and reduce volatility.

The building blocks for strong capital markets buttress the broader development of a prosperous economy. Strong capital markets require strong property rights; a robust supervisory regime with clear, transparent rules which strike the appropriate balance to ensure market integrity while promoting the entrepreneurial spirit and innovation; sound accounting standards; strong corporate governance; strong financial institutions; objective, independent financial information, analysis, and research; a meaningful disclosure regime; and independent credit rating agencies – each of which strengthens development in other sectors of the economy.

Efficient financial sectors are, in a sense, the central nervous system of modern economies, making countless decisions all the time to keep the body in good working order.

II. Role of Capital Markets for China

Well-developed financial markets are a necessary precondition for China's development as well – moving this nation toward its goals of more balanced, harmonious, innovation-based, and environmentally sustainable growth. Efficient, developed capital markets will allocate resources more effectively and efficiently, allowing China to continue growing at a healthy pace, while spreading prosperity throughout the economy and giving Chinese citizens a better return on their savings and investments.

China's growth is increasingly imbalanced – among regions, households, and sectors. These imbalances in economic structure and income inequalities differentiate China's current development challenges from those of past decades. Today, China's economy depends heavily on low-cost manufacturing goods, mainly for export. This has produced tremendous growth. But over-reliance on a single part of your economy has the potential to cause problems in the future. Your long-term economic strength requires a diverse economy, with high-value-added manufacturing and world-class services, including financial services.

China's most recent five-year plan acknowledges the need to achieve better balance in the economy, by increasing the role of the services sector, increasing the quality of inputs – not just their quantity – and developing a more innovative and technologically sophisticated economy. With a population aging as rapidly as that of any advanced economy, the five-year plan also recognizes the need to provide health care and retirement security for China's population. The Chinese people seek continued growth, with more innovation and harmony, so that the benefits of growth reach out from the cities into the country, from the coasts into the heartland, and to all the Chinese people.

Financial sector development is the key to China's transition into an economy that is less reliant on industrial activity, produces more high value-added products, and reduces the intensity of natural resources consumption. Your leaders recognize the power of financial markets to speed your transition to harmonious growth. Speaking at the National Financial Working Group meeting in January, Premier Wen said: "We must push financial reform and development into a new phase, and promote the complete development of a sustainable, healthy, and secure finance industry."

With an underdeveloped financial sector, investment in China doesn't reach its potential in generating returns, personal saving is not adequately rewarded, and risk is not appropriately priced, managed, and diversified.

Inefficient allocation of investment means fewer jobs are created for any given level of investment, inefficient companies fail to reform, new companies with higher-value added production are stifled, and growth remains less balanced.

Inadequate reward to savings hurts the Chinese people. While China's people work every bit as hard – if not harder – than people in other economies, they are not yet as well off. Today, Chinese citizens have $2 trillion – or 16 trillion RMB at today's exchange rate – deposited in banks, earning on average a 2.5 percent return. After inflation and taxes, the real return on bank deposits is probably negative. People in many other parts of the world have more choices of where and how to save, and routinely earn a much better return – often in the high single digits even in economies that are not growing nearly as fast as China.

If China's financial sector were developed and offered a variety of savings and investment securities and vehicles, the potential rate of return on a well-managed pension portfolio of financial assets in a rapidly growing economy like China's could be much higher, even if China's growth rate moderates over time Let us assume for illustrative purposes that rather than earning 2.5 percent, Chinese savers were to earn 8 percent over 30 years. The difference in the return on this 16 trillion RMB in savings would be truly significant due to the power of compounding. Instead of having 34 trillion RMB ($4 trillion) at the end of 30 years, Chinese households would have 160 trillion RMB ($20 trillion), which amounts to an estimated 124,000 RMB ($16,000) per capita. This is money that can be dedicated to meeting the Chinese people's needs, funding education and health care and securing retirement.

III. China's Reform of its Financial Markets

You have recognized that a deeper, more sophisticated, and more competitive financial sector will help you to achieve your aspirations of harmonious growth. And already you have made significant strides. I have seen your progress on a first-hand basis. China's banking, securities, and insurance sectors have all made substantial progress over the last 10 years.

Banking

You have recapitalized four of your top five state-owned banks and, even more importantly, invited in strategic investors and completed IPOs, which bring with them the added discipline of enhanced corporate governance, external audits, and new public shareholders. As someone who in my former job participated in and hopefully positively contributed to this process, I was highly impressed by the speed with which you move to execute a plan once your leaders have made a decision. The IPOs of your banks, like some of your earlier IPOs of state owned enterprises in other industries, were executed much more quickly than I have witnessed in any other country.

Corporate governance of large banks has improved considerably, with more qualified senior management and – in many cases – foreign directors. Non-performing loans are being reduced. And WTO commitments mean that foreign banks can now open 100 percent-owned subsidiaries without geographical restrictions.

Of particular note is the separation of responsibilities for monetary policy and financial stability, on the one hand, and the regulation and supervision of banks on the other. Regulatory transparency is also improving. Last fall, CBRC consulted extensively with foreign companies, the U.S. Treasury, and other regulators before issuing final regulations on the operations of foreign banks.

Securities Markets

China has also made significant improvements in its securities markets, including new accounting standards that were adopted at the beginning of this year. The proportion of non-tradable shares of listed companies has been reduced. The IPO market was reopened in mid-2006 to allow domestic investors to participate in the landmark bank share sales, as well as a number of others. Financially weak securities companies are being merged with stronger ones. Foreign participation in the equities market has increased, while Chinese investors have been given the right to invest in overseas stock and bond markets through approved funds. The People's Bank of China has created a vibrant short-term bond market. And the number of mutual funds and asset management firms has increased significantly, including through joint ventures with foreign companies.

Insurance

The quality of China's insurance companies is also improving, as foreign and domestic institutions expand into new regions and offer new products to better serve Chinese individuals and companies seeking to manage their risks.

The Benefits of Continued Reform

This nation is clearly on the right track, and further reforms lie ahead. As you develop deeper, more liquid, broad-based, and transparent markets with greater participation of sophisticated institutional investors – markets which are more representative and reflective of your strong underlying economic fundamentals – you will benefit from less volatility, better dispersion of risk, and greater stability. To achieve your goals of balanced and harmonious growth, there is much still to do in the development of open, competitive capital markets. And the experiences of nations around the world offer helpful advice in charting your own course.

IV. Structural Challenges Facing China

China's financial markets face four important structural challenges:

- Your capital markets remain underdeveloped;
- For all practical purposes, China has no institutional market;
- The banking system is also underdeveloped;
- And China lacks a predictable, transparent regulatory structure that fosters innovation.

Addressing these challenges is vital to China's long-term economic growth.

Capital Markets

As I said earlier, strong capital markets require strong property rights; robust supervision; sound accounting standards and corporate governance; strong financial institutions; objective financial analysis; a meaningful disclosure regime; and independent credit rating agencies.

The extent to which China's capital markets still need to develop becomes clear in comparison with other countries. A McKinsey study found that in 2005, equity market capitalization, excluding non-tradable, state-owned shares, was 17 percent of GDP. This is the smallest market cap ratio in emerging Asia, where the ratio averages 70 percent. Corporate bond issues by non-financial companies amounted to between 2 and 3 percent of GDP, compared with a typical 50 percent in other emerging Asian markets. Access to your markets is limited, restricting potential buyers, and bid-offer spreads are wide, indicating a lack of competition and liquidity. China's capital markets lack a diversity of products. And the quality of market participants varies widely.

Moreover, the Chinese private sector currently produces over half of the country's GDP and in some regions 75 percent of new jobs, yet state owned enterprises get three-quarters of the bank financing and account for most of the corporate issuances in the stock and bond markets. Few of your best companies are issuing securities in China. And for the most part, state-owned enterprises, with rising profits, don't pay dividends. As a result, most corporate investment is financed through retained earnings or the informal sector. This leads to less efficient investment because there is not a rigorous arms-length vetting process of a project's viability, and it leads to a more volatile investment cycle as companies tend to over-invest during good times when they are flush with cash.

To develop stronger capital markets, China needs a larger and more accessible government bond market, a more liquid and transparent corporate bond market, and a legal construct in which private equity can flourish.

Experience around the world shows that government bond markets are the first part of the bond market to develop. China's government bond market offers a very narrow range of products with only limited secondary market trading. By establishing a deeper government bond market with open access and competition, as well as more issues throughout the maturity structure, China can create a longer, more representative yield curve. And this will facilitate development of the corporate bond market by providing a reliable benchmark for pricing.

In addition to the difficulties caused by the immature government bond market, China's corporate bond market is underdeveloped in large part because of excessive regulation. Trading is segmented between an over-the-counter market and the listed bonds that trade on stock exchanges. These barriers should be removed.

China would also benefit by moving to a "disclosure-based" system in which regulators focus on ensuring that listed corporations provide the market with adequate information and investors decide who should get financing and on what terms. In this regard, we applaud recent announcements from the National Financial Working Conference that bond market development will be a high priority. A "disclosure-based" system also relies on good credit rating agencies, which need to be independent from the government and evaluate risk in an objective and systematic fashion.

Eliminating interest rate controls and requirements that long-term bonds receive guarantees from state-owned banks will facilitate the proper pricing of risk.

And a legal construct that allows for limited liability companies will help cultivate private equity and venture capital. Private equity and venture capital investors will channel resources to start-up companies, including those in the high-tech area, who might not yet be ready for market listing or for whom bank loans may be too expensive. This will move China toward its goal of becoming an innovative and knowledge-based economy. As President Hu said in January of last year, "The basic role of the market will be given a full play in the allocation of scientific and technological resources." Private equity and venture capital have a demonstrated record of directing resources to new, promising technologies.

Institutional Market and Asset Management

The cornerstone of developed capital markets throughout the world is the institutional market, and the mutual fund and asset managers who populate it. Institutional investors are the most rigorous in their analysis, and innovative in developing new securities and investment strategies. Yet China's markets lack these important elements.

Without a meaningful institutional investor base, the market relies too much on retail investors. The result can be a more speculative environment and a more volatile equity market. Private pension funds, mutual funds, and insurance companies are critical in providing long-term finance and improving corporate governance. A broader base of institutional investors and asset managers will lead to a wider array of market strategies, reducing volatility and the risk of "herd mentalities".

The development of a broad-based institutional investing market is being inhibited by a number of policies, including the fact that some important institutional investors, such as insurance companies, are highly restricted in the types of investments they can own. Big investors, such as insurance companies and pension plans, with large pools of capital, should drive the development of an institutional market when an appropriate tax and regulatory regime is in place.

Permitting professionals to enter the asset management business would strengthen the fiduciary role, protect investors, and develop trust in the industry. A switch to risk-based capitalization requirements in the asset management industry from a fixed minimum capital requirement would also be beneficial.

Banking

China's third challenge is a banking system which, while making progress, is still transitioning to a modern, efficient, market-driven system with proper controls, management, and professional staff. Some risk-averse credit officers may still believe it is safer to lend to state-owned enterprises backed by what they see as implicit government guarantees, rather than to dynamic small, medium-sized, and private businesses. In addition, corporate control of a massive and geographically dispersed branch network remains a challenge, and branch lending decisions are still often influenced by local pressures. And the lack of consolidated data reporting in Chinese banks means that the true extent of China's non-performing loans is unclear and provisioning is insufficient.

There is widespread recognition of what needs to be done to reform China's banking sector – better risk management; a more developed and accessible credit bureau; more consumer finance products; greater scope to set interest rates to reward depositors and price risk; consolidated supervision and reporting; greater competition, including of electronic payment systems; and opportunities for new banks to expand branch networks far more quickly. The insurance sector would also benefit from greater opportunities to expand branches in China.

Regulatory Regime

The final challenge China faces is a regulatory regime that may be inhibiting innovation and development of a modern financial market. As China transitions from a centrally administered economy to a market-based economy, its regulatory regime must adapt. Today, central authorities continue to be too involved in investment decisions that are more efficiently made by the market. For example, to get approval to issue bonds, no fewer than three government bodies must approve the details of a company's fundraising and investment plan – a construct unlikely to ensure that funds are directed to their most efficient use. The result is that it can take more than a year to issue a bond in China, compared to one or two months in Pakistan or the Philippines and less than a month in other Southeast Asian countries. Markets would better channel funds to the most dynamic sectors and businesses in the economy. The appropriate role for government is to set the rules for the market as a whole and enforce them – rather than to make individual investment decisions.

Government has a responsibility to set corporate governance rules and enforce them. But today, these rules are unclear and adherence to them is weak. In addition, Chinese accounting standards – although moving toward international standards – are in continuous flux, creating more uncertainty and weakening financial disclosure.

The continued large role of non-market factors that influence both state-owned enterprises and private enterprises – including financial services companies – stifles the dynamism of economic decision-making and the strength of regulatory integrity. Increasing the pace of privatization of state-owned enterprises would be beneficial. And state-owned enterprises should pay meaningful dividends if the cost of capital is to become a more meaningful concept in the Chinese economy.

It is clearly the government's responsibility to maintain a macroeconomic environment that supports harmonious growth. Right now, the combination of a rigid RMB exchange rate regime and large external surpluses means that there is a flood of liquidity into the banking system. The authorities mop up as much liquidity as possible. Twelve percent of assets in the big four banks are now sterilization bonds. Sterilized intervention hurts banks' income through higher reserve requirements or by forcing banks to buy PBOC bonds at low rates, which barely cover the banks' cost of funds.

Liquidity which cannot be absorbed is available to the banks for lending, running the risk of excess lending and future non-performing loans. Administrative controls to clamp down on lending are less effective in the larger, more market-oriented and globally integrated economy China has become. A more effective monetary policy – one less absorbed by managing the exchange rate – could assist efforts to reform the banking system, making it more market driven as well as help assure more stable growth.

V. Fostering Openness to Competition

China can make progress toward financial sector reform simply by making these domestic changes. But allowing much more foreign participation in China's financial markets would speed reform, as well as the stability and prosperity it will bring. I don't know of a single country in the world with a successful and sustainable well-balanced economy that doesn't have a strong capital market in place. And I cannot think of any such country that isn't open to competition – both domestically and from abroad.

In his National Financial Working Group speech, Premier Wen established a goal of – quote – "Opening up the financial sector wider to foreign financial help, and introducing advanced foreign management experience, technology, and personnel to accelerate the pace of innovation in China's financial system to improve efficiency and competitiveness."

Opening your capital markets to global competition and participation would bring many benefits: World-class financial institutions can introduce new technology and products to China, enhance training and the transfer of skills, improve market practices and infrastructure, and enhance financial stability.

Allowing Chinese banks to sell controlling stakes to foreign investors – currently capped at 25 percent – can promote China's efforts to strengthen risk management and internal controls in small and medium sized banks. Chinese banks would benefit from stronger credit analysis skills that enhance their ability to make sound loan decisions. And the banking sector as a whole would become more competitive as the capital markets develop and alternate sources of financing become available.

Opening to international competition does not mean compromising your own rules or identity. If China opens its markets to foreign participants, those participants will be subject to Chinese regulation and supervision. While undoubtedly international companies will have some foreign managers, the bulk of the people employed in China's financial services industry will be Chinese and the benefits generated will largely stay in China. Consider the large foreign investment banks in Japan, which are overwhelmingly comprised of and managed by Japanese professionals. As a matter of fact, they are almost as Japanese as some of the historically Japanese institutions. The wealth that is generated in Japan stays in Japan.

Foreign headquartered financial enterprises operating in China would provide tremendous resources for domestic skill development, and for training those who will become the leaders of China's financial industry, as well as future Chinese entrepreneurs.

China currently maintains tight caps on foreign participation in its capital market. Foreign securities companies can only own up to 33 percent of a joint venture and foreign asset management firms up to 49 percent of a joint venture. These limitations are among the most restrictive in large emerging markets.

Experience demonstrates that the joint venture model doesn't work in the securities sector, because investment banks are difficult to manage and control. The model of minority foreign stakes has not produced world-class investment banking institutions. China would

benefit by eliminating its ownership caps in the securities industry, as have almost all major developing countries, including Brazil, India, and Russia. This might not happen overnight, but the sooner the better.

To understand why this is true, let me briefly discuss an area I know something about – managing an investment bank. An important role of an investment bank is to serve as an intermediary between users and providers of capital. To do this well, these institutions must combine advisory, sales, risk management, market-making, and investing skills. Premier world-class institutions must combine the full range of these functions globally with capabilities in various domestic markets delivered by locals staffs trained and executing to international standards.

This business model is difficult to execute and it comes down to people – hiring and training the right people, and instilling in them proper values. Much of the training needs to be done on the job in both the commercial and the control side of the business. The management and control of these enterprises is very difficult even when there is 100 percent ownership by organizations with strong cultures and long institutional memory.

China also maintains tight controls over how much funding foreign companies can bring into the "A" share market through the Qualified Foreign Institutional Investor scheme. Despite the sharp rise in stock market capitalization and foreign exchange reserves, the quotas for QFIIs have barely budged. This slows development of the equities market, giving foreign investors access to less than two percent of the market capitalization of local exchanges, which deprives Chinese markets of buyers and expertise. Increasing QFII quotas will speed China's financial market development. Foreign securities companies are leaders in derivatives, yet only banks are allowed to trade them in China. Since all markets have periods of volatility, well-developed, sophisticated financial markets give investors the tools to manage volatility through a variety of financial instruments and techniques, including futures, and the ability to offset positions by borrowing and selling securities. The availability of these instruments also increases market liquidity and reduces volatility.

The Qualified Domestic Institutional Investor scheme is a good start in allowing Chinese institutions to invest overseas. Granting more QDII licenses to asset management firms to invest in overseas equities would open up new avenues for Chinese investors to diversify their financial assets and earn higher risk-adjusted returns.

Most nations recognize that large, well-managed securities and asset management firms which bring with them international best practices are critical to strong domestic capital markets. Nations that want robust, sustainable, harmonious growth do not impose caps. China is a large and powerful country, and you should not limit your own potential by restricting your access to world-class financial expertise that can enhance your capital markets.

VI. Conclusion

Time is of the essence. China's underdeveloped financial markets place the nation in a challenging position, trying to balance between a centrally administered and a market-driven economy. One lesson I have learned over the years is that although perhaps not as easy politically, it is better to implement reforms during periods of economic strength. The risks for China are greater in moving too slowly than in moving too quickly toward transparent, liquid, stable capital markets. The longer China waits, the more difficult it will be to create robust capital markets and reach your goal of more balanced, harmonious, and innovation-based growth. Some industries that may seek protection from competition will grow more politically powerful as they grow more economically powerful. That will make it more difficult to withdraw protection, to the detriment of a nation and its citizens who are deprived of world-class performance.

It's been said that everyone is in favor of competition, unless it is competition for themselves. Historically speaking, existing financial services companies tend to oppose liberalization and reform that brings new competition, even if it brings new opportunities and produces benefits for society overall. This has certainly been true of major financial sector reform in the United States and the United Kingdom, where market participants have almost always resisted change which increased competition in their sectors – change which ultimately proved to be beneficial to society as a whole and to the financial sector, which continued to grow and flourish with greater competition, efficiencies, and increases in employment.

To be sure, financial markets need to strike the right balance between supervision and regulation, and dynamism and efficiency. This is not an easy challenge to master. Yet the reality of the situation is that an open, competitive, and liberalized financial market can effectively allocate scarce resources in a manner that promotes stability and prosperity far better than governmental intervention.

Rebalancing your economy and welcoming international competition in the financial services sector is a win-win proposition. China and its major trading partners will benefit from increased prosperity that will strengthen other parts of your economy.

China's emergence as a global economic leader presents an important responsibility. All world leaders, including China and the United States, must maintain a transparent system of regulation and rule of law that gives international and domestic investors confidence in our markets.

I look forward to continued cooperation with Chinese leaders, particularly in the context of our Strategic Economic Dialogue, which is an important forum for discussing and managing our economic relationship. We received a very warm welcome in Beijing in December for our inaugural discussions, and I look forward to welcoming Madame Wu Yi and the Chinese delegation to Washington in May.

China has come a long way in developing its capital markets, but the journey is not complete. At the end of this road lie benefits for all the Chinese people. With visionary leadership and steady progress, these benefits are within reach. We wish you continued success as you

work to attain them. Thank you very much.

- 30 -