

Zhou Xiaochuan: Strengthen communication and cooperation between the Mainland and Hong Kong and promote the development of financial infrastructures

Speech by Mr Zhou Xiaochuan, Governor of the People's Bank of China, at the Seminar on Financial Infrastructures, co-sponsored by the People's Bank of China and the Hong Kong Monetary Authority, Beijing, 6 June 2006.

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Ladies and Gentleman, Dear guests,

Good morning.

I am glad to join in the Seminar on Financial Infrastructures cosponsored by the PBC and HKMA. I wish the Seminar a great success. In recent years, the economic ties between the Mainland and Hong Kong have become more and more closer. Promoted jointly by the PBC and HKMA, personal RMB business has achieved healthy development in Hong Kong, and the financial infrastructure cooperation between the two sides has progressed smoothly. To further enhance such cooperation, the PBC and HKMA established a financial infrastructure cooperation liaison group and a special working group in 2006. The Seminar was part of the cooperation program between the Mainland and Hong Kong.

Today, many experts and senior managements of financial institutions, including banks, securities companies and insurance companies and financial regulatory authorities attended the Seminar. Taking this opportunity, I would like to share with you my views on the topics of establishing and developing financial infrastructures in Mainland, cooperation between the Mainland and Hong Kong in financial core infrastructures, i.e. payment & settlement system and research on changes of international payment & settlement system and the promotion of modernized payment & settlement system as well.

Noticeably, there are many different interpretations of financial infrastructure. In this Seminar, financial infrastructure would possibly focus on payment & settlement system. But broadly speaking, financial infrastructure contains much more meanings, such as market infrastructure. I would like to focus on the development of payment & settlement system in line with the main contents of the Seminar.

I. Development of payment & settlement system vs. the role of central bank

It is well known that payment & settlement system is one of the most important financial infrastructures. The 11th Five-Year program clearly indicates efforts to improve payment & settlement system, enhance payment & settlement efficiency and develop sound financial market registration, custody, trade and settlement system. In a new economic and financial environment, the efficiency and safety of a payment & settlement system will not only affect public confidence on money and its transmission mechanism, but also play a crucial role by the central bank in monetary policy implementation, financial market development and maintaining financial stability. As a payment and settlement service provider, supervisor and operator of a modern payment and settlement system, the PBC has made great efforts in guiding and promoting the modernization of China's payment and settlement system. As an important component of financial infrastructures, the payment system demands the participation and cooperation of commercial banks and other financial institutions, despite their different roles in financial service in terms of establishment, development and operation.

The Mainland initiated the construction of payment system later than Hong Kong did. In Mainland, computer network and communication infrastructures indispensable to financial infrastructure are at different levels due to regional economic imbalances, given China has a large population and wide territory. Therefore, the Mainland must consider various elements such as business, technology and regional economic situation when constructing financial infrastructure. Currently, we focused on the construction of a payment system. The large value payment system has been extended nationwide in June 2005, and the layout of a modern payment system will be adjusted in accordance with technology advancement, the development of commercial banking business and data concentration level. The retail payment system is under construction and will be extended nationwide at end-June,

2006. At current stage, our priority is still on constructing a disaster back-up system, optimizing system functions and building a bill exchange system nationwide based on image technology.

II. Closer economic and trade ties between the Mainland and Hong Kong will provide much broader room for cooperation in financial infrastructure, especially the payment and settlement system.

The Mainland and Hong Kong have maintained good cooperation in economic and financial field for a long period of time. Particularly, after Hong Kong returned to the motherland in 1997, the first important cooperation was to face with the Asian Financial Turmoil. In recent years, with the increase in commercial, trade, investment and personal exchange between the Mainland and Hong Kong, cooperation became much smoother. The launch of CEPA not only produced zero tariff and facilitated commodity trade and transportation, but also promoted the fast development of service trade, such as the acceptance of professional certificates.

Cooperation in financial field between the Mainland and Hong Kong has also achieved great progress in recent years. In November 2003, with the authorization of the State Council, the PBC announced to provide settlement arrangement for personal RMB business of Hong Kong banks. Many new financial instruments were introduced in 2004, such as the RMB bankcards with Unionpay logo were accepted in Hong Kong from January 2004. In February 2004, participating banks in Hong Kong started to conduct RMB deposits, exchange and remittance business. From April 2004, RMB bankcards issued by Hong Kong banks were accepted in the Mainland. In November 2005, with approval of the State Council, the PBC extended the scope of the RMB business position squaring and settlement arrangement for Hong Kong banks including raising the upper limits of some business and allowing Hong Kong residents to pay their consumption expenditures with checks in RMB denomination. After the national social security funds being allowed to invest in Hong Kong and other overseas markets, with approval of the State Council, several policies were soon extended to facilitate different economic entities to invest in Hong Kong and other overseas market, including wealth management on behalf of clients, portfolio investment and insurance companies' overseas investments. In recent two years, Bank of Communications, China Construction Bank and Bank of China were listed in the H share market of Hong Kong respectively.

Strengthened connection in commodity and service trade, investment and financial cooperation has brought many new demands for the payment system and FX market. The growth momentum of such demands is fairly evident. At the same time, both sides' attention on the establishment of financial infrastructure could ensure the safety and efficiency of financial services. For example, people had various concerns before the launch of personal RMB business, but it worked out smoothly since all relevant parties made sufficient preparations. The practice also proved that. These all indicated a promising trend.

Turning to the Mainland, QFII was introduced into the Mainland in recent years, and in this year, policies aimed at differentiating domestic investors investing in overseas financial products were issued. At the same time, efforts were made to develop the FX market by providing more risk-control tools and introduce market makers and OTC transaction mode. Therefore, the construction of financial infrastructure will face higher demands, such as how to prevent settlement risks and increase settlement efficiency to meet changing demands of the market.

Financial service is similar as goods trade in certain aspects. A country could import goods or attract foreign capitals to produce it in its homeland when it could not make it by itself. As to financial service, sometimes a country is not able to provide all services or make every service good. So financial service, including infrastructure service can also be provided by others. The Mainland is now on the stage of improving the large-value payment system and establishing the retail payment system and disaster back-up system, therefore, Hong Kong is a good example for us to learn from its successful experiences in foreign exchange clearing and settlement. Additionally, Hong Kong is developing HK dollar vs. RMB settlement system as well. Such financial services can be learned and taken by both sides. Developing financial infrastructure cooperation between the Mainland and Hong Kong is also one of the results.

Of course, in terms of the strategy of financial infrastructure, the Mainland is aimed at establishing an integrated sound and effective payment system, which is a dynamic process that will develop a long time and with competition and cooperation. When taking advantages of Hong Kong financial infrastructures, we have to bear in mind that the Mainland still exerts control on RMB transactions in

several aspects. The 5th Plenum of the 16th CPC central committee reclaimed the direction of RMB reform is to realize full convertibility, but it will be a gradual process. While RMB was not a convertible currency, practices in RMB settlement and foreign exchange clearing and settlement should abide by relevant rules and regulations.

III. International payment & settlement system development trends and noticeable changes

A payment & settlement system develops in a complicated and sustainable dynamic manner. Technology advancement, financial market integration, legal framework and market competition, in particular the demands of financial market for payment & settlement efficiency and safety, are always the main factors that promote the development and changes of a payment & settlement system. Due to those factors, new trends have emerged in the global payment & settlement system and deserved close attention:

First concerning the arrangement and design of a payment & settlement system. Along with the aim of controlling legal, operation and financial risks of participants, a payment & settlement system should provide financial institutions with low-cost settlement credits and better liquidity saving mechanism so as to increase benefits in addition to providing infrastructure services.

Second, technology advancement, mainly computer network and electronic communication system development, propels the payment instruments innovation, payment process restructuring and reform. Internet and mobile payment tools, developed fast in recent years, have enlarged the services scope traditionally only provided by banks. Technology advancement leads payment process restructuring and reform, particularly continued strengthening of the compatibility, connection and resilience among the internal infrastructures of securities, foreign exchange, telecommunication and banks.

Third, a highly efficient, stable and organized market system should be developed in terms of payments services providing and pricing. Balance should be stricken between market innovation encouragement and fair competition as well as healthy market development in respect to regulation framework on market organization, behavior and coordination between main stakeholders and relevant service design, pricing and market arrangement concerning rules and practices. It will demand high supervision level on payment and settlement system.

IV. Key issues in the development of payment & settlement system of the Mainland

The abovementioned trends have also reflected development and reform of the payment & settlement system in China in recent years. Especially in the past 5 years, we have made noticeable achievements in the construction and development of the payment & settlement system. For instance, we established the RTGS large-value payment system nationwide and launched automatic pledge-based financing in May 2006 to facilitate the liquidity management of participants. Currently, the large-value payment system has realized interactive links among money market, bond market and foreign exchange market. DVP settlement was realized in bond trading and the open market operations of the central bank. At the same time, the payment system provided settlement channels for RMB settlement in foreign exchange trading, inter-bank business and bond issuance to reduce payment risks while enhancing payment efficiency. Administration of payment services market has been improved gradually, and financial institutions and market have provided increasingly many good innovative products along with the improved supervision on payment & settlement system.

However we should notice that, development of the payment & settlement system is a sustained and complicated process that deserves in-depth research on many issues. We have only established part of the system and thus need to develop and improve other parts. At the same time, commercial banks also made efforts to develop more advanced system to better meet market demands. We should follow the new trend and adopt new technologies. A unique economic science, called Payment Economics, which focuses on money exchange mechanism is emerging abroad. Concerning the fast changing financial environment, payment & settlement system as the core of financial infrastructures has abundant contents for us to research and explore. I would like to share with you my ideas as the following:

First, the influence of highly efficient large-value payment system on commercial banks' liquidities and central bank's monetary policy warrants high attention.

Second, there are rooms for improvement in legal aspect of the payment & settlement system. A safe and efficient national payment & settlement system requires a transparent, comprehensive and sound legal framework. With development of the payment & settlement system, some flaws in payment regulations gradually attracted people's concerns. For example, payment effectiveness of market participants under bankruptcy and settlement finality of the payment system needs to be clarified by law. *Law on Negotiable Instruments and Rules on Payment and Settlement* demands further amendment and improvement to adapt to the new economic situation. Some products innovations such as Internet payment, mobile payment and other electronic payments may face risks without prudent regulation. Institutional arrangement on the payment service market and supervision over market behaviors requires further clarification and coordination.

Third, increasingly more cross-border financial activities set high demands for an efficient functioning of and supervision on the payment & settlement system. Economic globalization has caused increased cross-border financial activities, which requires more multi-currency cross-border payments, so the traditional payment system focusing on providing settlement services for domestic financial institutions have evolved along such changes, for example the upgrading of European cross-border payment system (TARGET), multi-currency foreign exchange trading settlement services provided by the CLS, the settlement arrangement for US Dollar and the Euro in Hong Kong market etc. In particular, the foreign exchange payment system of Hong Kong did not settle in central bank money but realized real-time ultimate settlement through commercial banks' accounts based on clear settlement rules, which has great significance to the settlement arrangement in Mainland financial market.

Fourth is relevant to the coordinated development between large-value payment system and the securities settlement system. The latest research of the BIS concluded that, the large-value payment system of a country should develop harmoniously with the securities settlement system to ensure safety and efficiency of a financial system. One important reason behind it stems from the interdependent relations between the large-value payment system and the securities settlement system. Specifically, capital settlement in a securities system could realize DVP through the large-value payment system so as to prevent payment risks. At the same time, the large-value payment system provides liquidities for participants according to their pledges to reduce liquidity risks, which needs the support of securities system in return. Turning to the current situation in China, the CBGS has built interface with the large-value payment system, while the securities settlement system of the Stock Exchange are under study for how to connect due to many factors. It is important to tackle the coordinated development between the large-value payment system and the securities settlement system.

Fifth, in order to promote the long and coordinated development of all components of a country's payment system, some economies have established special payment and settlement development committees comprised of different members either all from the central banks, or from the central banks, relevant regulatory authorities and commercial institutions. The mode of establishing the payment & settlement system development committee could be explored to examine whether it is suitable to China's practice.

In short, the Mainland needs to further improve the local currency payment system since we depend on telecommunication and computer network in such a wide territory. Hong Kong has its advantage on foreign exchange clearing and settlement and providing payment services for capital market and FX market. Both sides are complementary to each other in financial infrastructures with different comparative advantages, and could have more rooms of cooperation. Moreover, development of the national payment & settlement system relies on joint endeavors of the central bank, regulatory authorities and various financial institutions. I believe, with our strong confidence and unremitting efforts, payment & settlement system, either in the Mainland or Hong Kong, will have promising perspectives.

Thank you.