Philip Lowe: The journey of financial reform

Address by Mr Philip Lowe, Deputy Governor of the Reserve Bank of Australia, to the Australian Chamber of Commerce in Shanghai, Shanghai, 24 April 2013.

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It is a great pleasure to be here in Shanghai today. I would like to thank AustCham Shanghai for the invitation to speak at this lunch.

As you may know, the Reserve Bank of Australia's head office is located in Sydney. I mention this because Shanghai and Sydney share a number of similarities. Both cities are vibrant and cosmopolitan places to live. Both host their country's main stock exchange as well as futures markets. They are both also centres of banking and funds management and are important financial hubs in the Asia-Pacific region.

It is this financial link that provides the cue for my remarks today. The financial sector plays a critical role in both our economies and the financial linkages between our two countries are gradually deepening. These stronger financial linkages hold the promise of significant benefits for both our countries over the years ahead, just as the stronger trade linkages have benefited us both greatly over the past two decades.

This afternoon, I would like to begin by highlighting how the financial linkages between China and Australia have grown over recent times and the potential for these linkages to grow substantially further. One of the factors that will obviously influence the speed with which that happens is the pace of reform in the Chinese financial system itself. As Australia's experience illustrates, the journey of financial reform can be a difficult one. But our experience also suggests that it is a journey that is well worth taking. In particular, it is a journey that can promote the efficient allocation of savings in the economy and enhance overall living standards. In many respects, the issues that China faces are similar to the ones that we confronted. So I thought it might be useful to share with you some of the details of our own journey of financial reform.

A deepening financial relationship

As is now well understood, Australia and China enjoy a very strong trade relationship. China is Australia's largest export destination, and it is also the largest supplier of imports into Australia. In the most recent year, 26 per cent of Australia's exports went to China and 15 per cent of our imports came from China (Graph 1). From the Chinese perspective, Australia is also an important trading partner, accounting for around 5 per cent of total Chinese imports and a much higher share of some categories of imports, most notably iron ore.

I recount these facts, because a strong trading relationship provides the basis for a strong financial relationship. As history shows, finance follows trade. As trade linkages increase, firms require an increasing array of financial services. And a strong trading relationship helps businesses in both countries identify and develop investment opportunities in the other.

There are five elements of the financial relationship between China and Australia to which I would like to draw your attention.

1. RMB trade invoicing

The first is the potential for a substantial increase in the share of trade between our two countries that is invoiced in RMB. The latest available data from the Australian Bureau of

Statistics (ABS) suggest that currently the RMB is not widely used as an invoice currency for trade between China and Australia.[1] At the same time though, many Australian businesses are beginning to explore this possibility. This is evident in a recent survey organised by the Reserve Bank of Australia as part of the inaugural Australia–Hong Kong Renminbi Trade and Investment Dialogue held in Sydney a couple of weeks ago.

From this survey it is clear that many businesses are interested in using the RMB for trade settlement.[2] They see it as a way of building relationships with their trade counterparties and reducing costs. There are, however, a number of factors that have been identified as slowing the uptake of invoicing in RMB. Perhaps the most important of these is the availability and pricing of instruments to hedge RMB currency risk. While these instruments have developed significantly over recent years, the relevant markets are not yet as deep and liquid as some others. Another factor constraining uptake of the RMB is the administrative difficulties that some companies have experienced in the settlement process. These difficulties arise not just from the exchange controls in China but also from processing problems that can occur during the transaction. A number of the Australian companies have also noted that some of their Chinese counterparts have, to date, had only limited appetite for invoicing in RMB.

In time, it is likely that these constraints will be overcome: deep and liquid markets will develop, settlement processing will be improved and the appetite for invoicing in RMB will grow. If this assessment is correct, then it is likely the RMB will become the invoicing currency of choice for many businesses on both sides of our trading relationship.

2. Direct trading between the onshore RMB and AUD

The second element of the financial relationship that I would like to draw your attention to is the announcement two weeks ago of direct trading between the Chinese renminbi and the Australian dollar in the onshore market. There are only two other major currencies – the US dollar and the Japanese yen – for which onshore direct trading with the renminbi (without the use of an intermediate third currency) is possible. Over time, this important initiative should promote trade invoicing in RMB and facilitate bilateral trade and investment.

3. Swap agreement between PBC and RBA

The third element is the swap agreement between the People's Bank of China (PBC) and the Reserve Bank of Australia (RBA). The PBC and RBA have a strong and cooperative relationship. The PBC has an office in Sydney. And the RBA has an office in Beijing. The swap agreement was signed in March 2012 and allows for the exchange of local currencies between the two central banks of up to A$30 billion or CNY200 billion, making it the fourth largest RMB swap agreement. In the event that this swap were to be activated, it is the RBA's intention to make RMB available to all authorised deposit-taking institutions (ADIs) in Australia through a standing facility, with ADIs being charged SHIBOR plus 25 basis points. ADIs would, of course, need to provide the RBA with Australian dollar collateral, in the same way that they do in our regular market operations.

We see this swap agreement as another important piece of the financial infrastructure supporting trade and investment between China and Australia. Its existence provides market participants with greater confidence regarding the availability of RMB liquidity in Australia,

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[1] ABS data published in June 2012 show that the value of Australian merchandise trade settled in currencies other than the US dollar, Australian dollar, euro, New Zealand dollar, UK pound sterling and Japanese yen was around 1 per cent of total merchandise trade, indicating that the share of Australian merchandise trade invoiced in RMB in the June quarter 2012 was very small.

[2] For a summary of this survey, see 'Corporate Attitudes Towards Renminbi Trade Settlement and Investment' available at <http://www.treasury.gov.au/RMBDialogue>.

particularly during times of stressed market conditions. In turn, this greater confidence should help build a solid platform for the growth in the RMB market in Australia.

4. *Investment of foreign currency reserves*

The fourth element of the growing financial relationship between China and Australia is a recent decision by the RBA to invest some of our foreign currency reserves in China.

This decision by the RBA represents the first time that the RBA will have invested directly in a sovereign bond market of an Asian country other than Japan. This decision does, however, build on our existing investments in the EMEAP Asian Bond Fund initiative, which were made in 2003 and 2005.

Our current intention is to hold around 5 per cent of Australia's foreign currency assets in China. The PBC has approved an initial investment quota and we are currently working through the necessary agreements prior to the investment being made.

This decision to invest in China is an important one. It reflects the broader economic relationship between China and Australia and our increasing financial ties. It provides greater diversification of our investments and will help with our understanding of the Chinese financial markets. Over the long run, and particularly as capital account liberalisation occurs in China, the RMB is likely to become one of the major reserve currencies of the region.

5. *Bilateral investment flows*

The fifth and final element is an increase in other capital flows between our two countries, including direct investment, portfolio investment and banking flows.

These two-way investment flows are still in their infancy, but they have grown rapidly in recent years. According to data from the ABS, Chinese investment in Australia has risen more than fivefold since 2006, with the stock of investment reaching around A$20 billion as at end 2011 (Graph 2).[3] Australian investment in China has also risen significantly over this period, with the stock reaching A$17 billion in 2011. It is likely, however, that these data understate the size of bilateral investment, as some funds are intermediated through financial centres including Hong Kong.

A significant share of the growth in Chinese investment in Australia thus far has been foreign direct investment. This has been largely in the resources sector, although recently there has been some diversification, including into the services and real estate sectors.

Direct investment has also been an important component of Australia's investment in China including investments in financial services. In recent years, Australian banks have increasingly facilitated Australian investment in China through their provision of cross-border banking services.

All of Australia's major banks – a number of which are represented here today – have a growing presence in China, as is evident in the foreign claims data (Graph 3). Although each bank has its own strategy, all recognise the opportunities that China offers, whether through servicing new Chinese customers or through supporting Australian businesses' trade with China. Other areas of the Australian financial services industry, including in insurance, are also active in China, although the size of their investments are, at this stage, limited by various regulations. Conversely, three Chinese banks have opened branches in Australia in the past few years, joining Bank of China which has had a longer-standing presence in Australia.

Looking forward, increased two-way investment flows have the potential to benefit both countries. Chinese investment in Australia can help to fund important investment projects

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[3] Data for 2012 are due to be released by the ABS in the next week.

and support the long-term trading relationship. It can do this through direct ownership of projects and indirectly through the capital markets. Conversely, Australian investment in China offers the possibility of further diversification of Australia's large pool of superannuation savings, particularly in long-term infrastructure assets, which are a good match for the liabilities of retirement funds. There are also benefits from sharing financial expertise and technology.

The reform journey

Together, these five elements – RMB trade invoicing, direct trading between the RMB and AUD, the swap agreement between the PBC and the RBA, the investment of foreign reserves in China and the increase in investment flows – are testimony to the maturing of the financial relationship between our two countries. The financial architecture to support this relationship is incrementally, but inexorably, being put in place. It is being supported by governments in both countries and by businesses, including those in the financial industry.

There is still, however, a lot to be done. Both countries are still learning about the business, social and political environment in the other country. A deeper financial relationship requires businesses to gain experience in local markets so that they can recognise and benefit from investment opportunities. This takes time. Businesses also need to understand the regulatory environment, which continues to evolve in both countries. Over recent years, the Chinese authorities have taken steps to liberalise interest rates and parts of the capital account, although the financial system is still highly regulated. Substantial capital controls remain in place. The Chinese currency does not float freely, notwithstanding the gradual widening in the trading band over recent years. And deep and liquid financial markets in the full range of investment and hedging instruments are still some way off. So there is much work ahead if the depth of the financial relationship is one day to match the depth of the trading relationship.

The pace of reform in China will have an important bearing on how this work progresses. As we know from our own experience, this reform process is a difficult one. And from some perspectives, China faces an even more daunting challenge than the one we faced. Because of China's sheer size, the rest of the world is watching very closely and it has a strong interest in China "getting it right". China is also facing the task of liberalisation at a materially lower level of per-capita income than was the case in Australia. It faces an existing financial sector much larger (relative to GDP) than was the Australian financial sector at the outset of our liberalisation process. And financial systems everywhere are more globally connected than they once were, so the potential pressures on the Chinese system are greater than when Australia went through reforms.

From my perspective though, a number of the discussions that are occurring today regarding the Chinese financial system have a degree of familiarity about them.[4] I would like to mention three of these.

The first is the discussion about "shadow banking". This is very familiar. In the 1970s, Australia had a highly regulated banking sector – with regulations on interest rates, the rate of bank balance sheet growth and structure of those balance sheets. The result was rapid growth in other types of financial institutions. Indeed, by the early 1980s, the banks' share of the financial system had fallen to 40 per cent from 70 per cent in the early 1950s.

We made various attempts to restrict the activities of the "shadow banks", but whenever we introduced new rules, other entities emerged. China is experiencing this today. Finance can be very flexible – those who want to borrow money seem to find a way of connecting with those who have money to lend. In our case, the financial stability problems we had in the

[4] For discussions of the financial reform process in Australia see the list of references.

1970s were in those parts of the industry that grew up outside the regulatory net. This regulatory net also contributed to inefficiency in the financial system by limiting banks' ability to respond to the needs of their customers. In particular, the various regulations limited the availability of credit to important parts of the economy.

In the end, the only practical solution was to move to a more liberalised system. We had a number of public enquiries to guide the process, including the development of a regulatory framework that sought to strike the right balance between prudential regulation and market competition. Of course, this is an on-going endeavour and the journey is never ending.

A second familiar discussion is that about the exchange rate and the openness of the capital account. In the decades leading up to the 1980s, Australia experimented with almost every type of exchange rate regime. We had a peg to the British pound (1931–1971), a peg to the US dollar (1971–1974), a peg to a trade-weighted index (1974–1976) and then a crawling peg against a trade-weighted index (1976–1983). Ultimately, none of these proved sustainable.

These various regimes were complemented with a range of capital controls, which provided some degree of control over domestic monetary policy. Over time, however, people got better at finding ways around these controls and true control over domestic monetary policy proved elusive. While the controls were gradually eased, the highly managed exchange rate regime with a partially open capital account was conducive to neither domestic nor external balance.

After we had tried everything else, in the early 1980s we switched to a floating exchange rate and an open capital account. This decision has, perhaps, been more important than any other single decision in promoting stability of the Australian economy. It has allowed Australia to run its own monetary policy, to tap into the gains that can come from the international flow of capital, and to benefit from the stabilising properties of a flexible exchange rate in a world where there have been very large shocks, including to our terms of trade.

A third familiar discussion relates to the need to develop supporting financial infrastructure before liberalisation takes place. Those who wanted a slower pace of financial reform in Australia would sometimes argue the preconditions were not right – that now was not the time to move; that banks didn't have the necessary credit assessment skills; that the hedging instruments didn't exist; and the relevant markets were neither deep nor liquid. What we found, however, was that it was the restrictions themselves that were often preventing this supporting infrastructure from developing. A highly restricted system was simply not conducive to banks building the relevant credit assessment skills, or the development of hedging instruments, or the emergence of deep and liquid markets. When the regulations were lifted, the system began to respond. Allowing prices to move meant that markets developed. And, allowing banks to decide how much to lend, and to whom they would lend, saw them invest in credit assessment skills.

It is important though to point out that the process was far from smooth. Mistakes were made. Banks that had become used to lending to just the best-quality borrowers had trouble coping with a world in which they could lend to anyone and there were market pressure to grow rapidly. They took time to develop the skills to assess borrowers lower down the credit spectrum, and while they were learning they made a lot of bad loans. The regulatory and supervisory apparatus was also too slow to develop. Like the bankers, the regulators who learnt their craft under the highly regulated system took time to adjust.

While these aspects of Australia's experience have some similarities with the current Chinese experience, China needs to, and is, charting its own course. There are many possible paths of financial reform and each has advantages and disadvantages. The exact path taken by any country on the journey of financial reform will obviously depend upon its economic and financial conditions. China has seen the mistakes that others have made and it has been able to draw some lessons from these mistakes. China's early adoption of some

of the new Basel regulatory requirements can clearly be seen in this light, as can the gradual liberalisation of the capital account and of domestic interest rates.

The point I want to emphasise though is that having undertaken our own broad journey of financial reform, we are glad we did so.

The reform process in Australia took many years. At the outset of the journey, as well as at critical points along the way, there was considerable concern about how things would work out. It was often two steps forward, one step back. And even some decades on, the behaviour of financial institutions and the way markets function still raises questions. One current example of this is related to the very high value of the Australian dollar, which is clearly making for difficult conditions in certain parts of the Australian economy. The quantitative easing that has taken place in a number of countries is having a significant effect on exchange rates of freely floating currencies, and this is having ramifications for monetary policy in these economies. No doubt, other issues about the behaviour of markets will arise in the future.

But for all of this, the financial reform journey in Australia has been a positive one. The challenges of managing our liberalised financial system are formidable. But they are less formidable than those of managing a system in which key prices had trouble moving, markets were shallow, the terms and availability of credit were restricted, and almost everybody in the system had an incentive to find ways around the multitude of restrictions.

In the end, the long process of financial reform in Australia has helped promote economic stability as well as the efficient allocation of domestic savings. It has improved the access by businesses and households to credit and improved competition and innovation in the financial system. It also has allowed Australia to participate more fully in the global economy. And, most importantly, it has helped raise the average standard of living in Australia. I suspect that one day China will be able to make the same claims as it too continues with its own journey of financial reform.

Thank you for your time this afternoon.

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Graph 1

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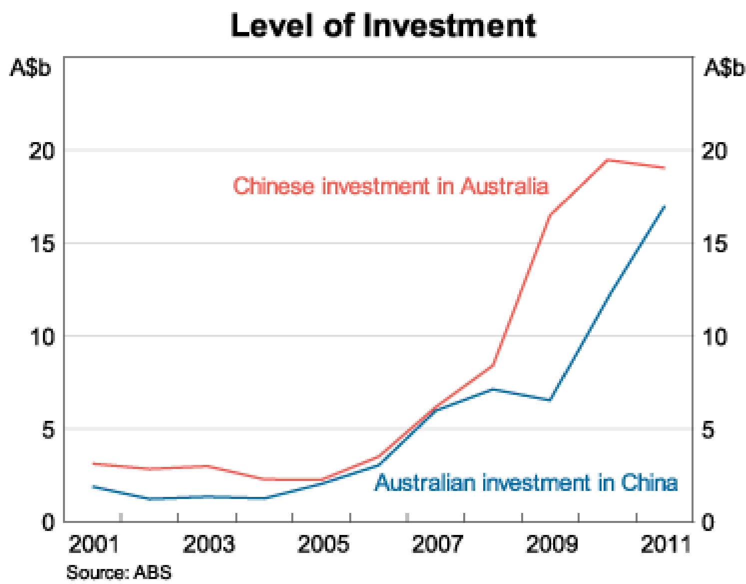
Graph 2



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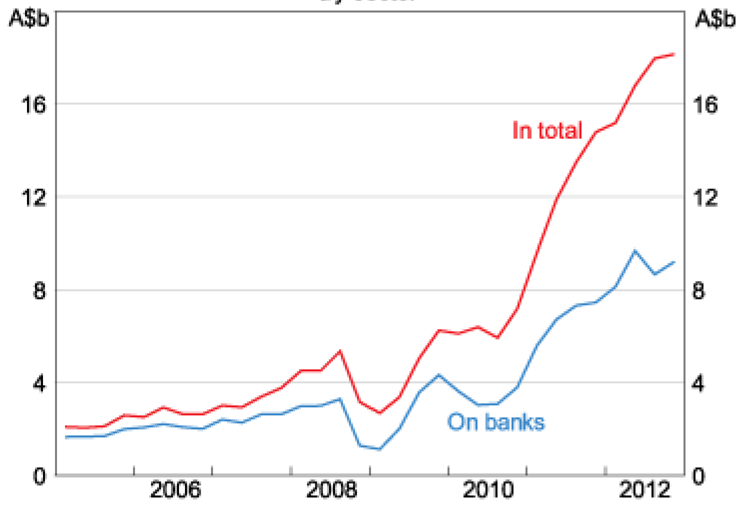
Graph 3



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