High-level policy panel on financial stability issues

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As a panellist, I would like to talk about financial stability. The subject covers theoretical thinking on the model to be chosen or repaired. It relates to supervisory and regulatory reform, to our analytical framework, and, on the technical side, to the need to find new tools for our toolkit to ensure financial stability. I also want to touch on thinking in China about this subject. As I have talked about these topics on a variety of occasions, at the BIS, the IMF, the FSB, and in the Asian Pacific EMEAP meeting in Hong Kong, today I would like to discuss what kind of model China can choose to safeguard financial stability in the future.

Maybe this is related to Charles Goodhart's topic. Personally, I am very interested in this theme, because in the early 1990s we made various studies in China with a view to pushing forward economic and financial sector reform. On two important issues, ie the corporate governance model and the financial sector model concerning the relationships between banks and clients, we studied the Anglo-Saxon, the Rhine, and also the Japanese and Korean models. I do not think there is yet a Chinese model. China, as an economy in transition, does not have a market tradition. Certainly the economy has certain characteristics. For example, state ownership still plays a large part in the ownership structure. And the older generation has its doubts about the efficient market hypothesis. They cite cases of market failure and argue that government intervention is necessary. Yet all these traditions are changing quite fast.

In the crisis, we need to think about how to formulate a model for the future, one that is not only conducive to financial stability but one that also helps the financial sector to support the real economy. This is an important juncture for China and maybe for other countries in thinking for the future. Charles, in your presentation, you talked about the possible convergence of the Anglo-Saxon model with the Asian ones. Clearly, you had the intention of saying that the efficient market hypothesis is correct. The problem is that sometime a tail event occurs, which may be especially serious when several low-probability events happen together and reinforce each other. Unfortunately, the tail can become quite fat on such an occasion. This raises a number of questions, such as whether or not the risk control model is appropriate for microeconomic institutions, and whether our supervision is adequate. If it is a low-probability event, remedies may exist on the tail side. When a tail event happens, what kind of emergency remedies are available? And, in the case of conditional probability, how do we prevent conditions from moving into the tail side and how do we prevent the tail from becoming fat? In other words, how do we improve risk control models and supervision? In a crisis, we may have to resort to nationalisation or government intervention. But, things should go back to normal if the efficient market hypothesis is valid. Hence, with some improvements in the Anglo-Saxon model, it might be possible to live in the same world as before.

In China, we have had a similar discussion. We use the efficient market hypothesis, meaning that the financial markets, especially the capital markets, contain all important information about the crisis. Somebody is certainly going to challenge this notion: for example, why did prices fail to contain information about this crisis, and why did unhealthy phenomena, such as very high leverage and subprime products, occur? In China, the efficient market hypothesis is often questioned.

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For anti-crisis purposes, Keynesian measures can be used, as we saw in China during the Asian financial crisis in the late 1990s. So we have had the experience of using this kind of policy to get China out of a crisis. There has been a great deal of academic discussion about liquidity traps, as described by Keynes many years ago, and about proposals for Keynesian intervention, ie about public finance for larger rescue packages. However, the outcomes have been mixed and controversial.

In my view, it is dangerous to misread historical experiences and to depend too much on Keynesian models for the future. It is fundamental for us to re-think this issue and I hope that our discussions will also provide a clearer picture for decision-makers in dealing with this crisis, and also for the future. Thank you.